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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. .....

MARGARET L. HOLT and KATHLEEN L. McMAHON, individually and on behalf of all other shareholders of Alleghany Corporation similarly situated,

Petitioners,

v.

ALLAN P. KIRBY, CHARLES T. IRELAND, JR., FRED M. KIRBY and ALLEGHANY CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Margaret L. Holt and Kathleen L. McMahon petition for a writ of certiorari to review the judgment of the Court of Appeals for the Second Circuit entered in this case on January 12, 1965.

OPINIONS BELOW

The opinion of the Court of Appeals *en banc* is reported *sub nom. Alleghany Corp.* v. *Kirby,* 340 F. 2d 311 (1965) and is printed in Appendix A, *infra,* beginning at p. 1a. The opinion of the original panel of the Court of Appeals is reported at 333 F. 2d 327 (1964) and is printed in Appendix

B, *infra,* beginning at p. 4a. The opinion of the District Court is reported at 218 F. Supp. 164 (1963) and is printed in Appellant's appendix on the appeal to the Court below (pp. 124-172a).

JURISDICTION

The judgment of the Court of Appeals was entered May 19, 1964. Rehearing *en banc* was granted July 22, 1964, and the judgment on rehearing was entered January 12, 1965.

On April 12, 1965, an application was made by petitioners for an extension of time within which to file a petition for a writ of certiorari. On the following day, Mr. Justice Harlan granted such an extension until five days after the Court of Appeals decided an appeal from the District Court's denial of petitioners' application for intervention to file this petition or until April 29, 1965, whichever was earlier (App. C, 51a, *infra*). The appeal resulted in an affirmance (2-1) of the denial of intervention on April 21, 1965, and the application to Mr. Justice Harlan was renewed on April 23, 1965, to prevent the time on this petition from expiring while a petition was prepared as to the denial of intervention.

On April 27, 1965, Mr. Justice Harlan granted a further extension of time to file a petition for certiorari to and including May 12, 1965, provided that a petition for certiorari to review the Court of Appeals' denial of petitioners' application for intervention be filed on or before May 12, 1965 (App. D, 53a, *infra*). The intervention petition is being filed simultaneously with this petition.

The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED

1. Where federal statutes (Section 14(a) of the Securities Exchange Act of 1934 and Rule X-14A-9) impose upon corporate directors standards of disclosure deemed necessary for the protection of the interests of minority shareholders, must a federal district court apply a comparable federal standard of disclosure in determining whether derivative actions alleging violation of those statutes have been fraudulently settled?

2. If application of a comparable federal standard of disclosure requires that the settlement be set aside, should the fact that such settlement had been approved by a state court judgment prevent a federal district court from barring the use of such judgment in a pending parallel federal action or from setting that settlement aside because of (a) the doctrine of *Erie* v. *Tompkins,* (b) the principles of *res judicata,* or (c) considerations of comity, even though the fraud leading to the settlement has been committed on the federal as well as the state court?

3. If state rather than federal law is to be applied, was it correctly applied in this case?

4. Should the court below have set the challenged settlement aside because counsel, who purported to represent the corporation before a federal court which lifted an injunction barring the settlement, concealed from that court the fact that he had represented a defendant-director in the secret negotiations which led to the settlement, and that he was not, in fact, giving the corporation the independent representation the law demands?

If this petition is granted, the following question will also be raised:

5. Did the state court have jurisdiction to authorize the settlement of the exclusive federal claim being asserted here? If not, can that court's approval of the settlement bar prosecution of that claim which is still pending in the federal district court?*

STATUTE AND RULE INVOLVED

The relevant provisions of the Securities Exchange Act of 1934, 15 U. S. C. §§ 78b, 78n, 78aa, and Rule X-14A-9 are set forth in Appendix F, *infra,* beginning at p. 57a.

STATEMENT

This action was instituted to set aside the fraudulent settlement of prior derivative actions and thereupon to require return to Alleghany of stock taken from its portfolio, or damages measured by the value thereof. The prior actions, which were pending in the District Court for the Southern District of New York and New York County Supreme Court, claimed, among other things, that the principal defendant here, Allan P. Kirby, and others, unlawfully acquired 48,225 shares of stock of Investors Diversified Services, Inc. ("IDS") from the investment portfolio of Alleghany Corporation. Such claims were based upon an asserted violation of Section 14(a) of the Securities Exchange Act of 1934 by means of false and misleading proxy material utilized to solicit shareholder approval of the transaction in question. It was also alleged in the prior actions that the same facts gave rise to a common law lia-

*This question, unlike the other questions, was answered affirmatively 8-0 by the *en banc* Court of Appeals in a footnote to its per curiam opinion on rehearing (340 F. 2d at 312, n. 1). We believe the Court was in error.

bility. All of the prior actions were settled with judicial approval in December 1959.

The gravamen of the present action is that the settlement was accomplished by the continuing failure to disclose, indeed, by the active concealment from the plaintiff shareholders and the courts in the prior suits, the same material inside information that should have been disclosed in the first instance to the shareholders whose proxy approval of the transaction was solicited.

Specifically, the present suit claims:

1. That stock worth $60,000,000 was illegally taken from Alleghany's portfolio (App. B, 38a, *infra*). No dispute as to this claim exists in the Second Circuit. Even Judge Moore, writing for the 2-1 majority of the original panel which affirmed dismissal of the complaint, stated:

> "There can be no question that the exchange transaction perpetrated by Kirby, Young and Purcell violated fundamental legal principles against self-dealing. If the purchase of IDS was thought to be advantageous for Alleghany over a period of years, there was no justifiable reason for these officers to take this advantage away from the corporation to which they owed fiduciary duties." (App. B, 17a, *infra.*)

2. That the illegal transaction was accomplished by a violation of Section 14(a), in that the proxy material seeking shareholder approval of the transaction was false and misleading (App. B, 6-7a, *infra*). This claim is also undisputed in the Second Circuit. Again, in the words of Judge Moore,

> "Nor can there be any question that the proxy statement on the basis of which stockholder ratification was sought was misleading, both in its state-

ments and particularly in its omissions." (App. B, 17a, *infra*).

3. That the claim asserted in both the federal and state courts based on the illegal taking and the violation of Section 14(a) was the subject of a fraudulent settlement made possible by continued concealments of material evidence which only came to light upon a change in management (App. B, 5a, *infra*).

It was on this issue that the Court of Appeals split.

Judge Moore, writing for the majority, conceded that directors have a duty of full disclosure prior to litigation but held that when litigation begins, the duty to disclose ceases completely (App. B, 16a, *infra*).

Judge Friendly in dissent stated that the bringing of a suit could not signal the lowering of the standards of disclosure. He said that he could "perceive no principle that would eliminate or even lessen the fiduciary obligations of directors who wish to settle a derivative action wherein they are charged with self-dealing . . ." (App. B, 28a, *infra*).

(a) The Illegal Transaction

In December, 1949, Kirby, then president of Alleghany, with his co-fiduciaries, Young (Chairman), Purcell (Vice Chairman), and Anzalone (Secretary), voted as directors to offer themselves from Alleghany's portfolio 48,225 shares of the Class A (non-voting) stock of Investors Diversified Services, Inc. ("IDS") (App. B, 5a, 41a, *infra*), an investment advisor and registered face amount certificate company (Pl. Ex. 17, App. A, 676a, ¶ 19(2)). These 48,225 IDS non-voting shares had been purchased by Alleghany at an average per share cost of $8.15 in April 1949, when it also purchased the controlling block of IDS voting shares (App. B, 40a, *infra*). Alleghany made such purchases for

its portfolio as a long-term investment (App. B, 17a, 42a, 46a, *infra*).

At the December, 1949, meeting, only seven of Alleghany's ten directors were present, and of the seven, four (Kirby, Young, Purcell and Anzalone) were the interested director-officers referred to above (App. B, 5a, 41a, *infra*).*

In May, 1950, the offer to the interested directors was purportedly approved at a meeting of shareholders (App. B, 13a, 44a, *infra*). All of the judges of the original panel of the Court of Appeals were of the view that such approval was obtained by means of false and misleading proxy material (App. B, 17a, 44a, *infra*). In particular, the insiders had knowledge before the proxy material was prepared of IDS internal projections and independent actuarial studies showing an extraordinary rise in the prospective earnings of IDS (App. B, 10-12a, 30-33a, 37a, 39a, *infra*).** One such report reliably projected IDS earnings for each of the shares that Kirby, Young, Purcell and Anzalone planned to acquire from Alleghany at a *price* of $8.15 per share as follows (Pl. Ex. 245 id., App. A, 531-45a):

1950	$24.56
1951	15.85
1952	13.28
1953	15.17
1954	18.11

*See Judge Friendly's dissent, which notes that the absent members included two lawyers and an investment banker (App. B, 41a, n. 6, *infra*).

**Hereinafter references to the various appendices in the principal appeal and the intervention appeal will be as follows:

"App. A, 269a": Appellant Alleghany's Appendix in the principal case.

"App. Int. A. 6a": Appellants Holt and McMahon's Appendix in the intervention appeal.

References to any matter in the record below which has not been printed will be preceded by "R.".

The earnings per share in 1948 had been only $1.25 and in 1949 about $5 (App. B, 41a, *infra*). None of the inside information revealing the prospective rise in IDS earnings was given to the other directors or to the shareholders in the proxy statements soliciting ratification of the transaction (App. B, 44a, *infra*).

Shortly after the acquisition, the IDS stock, consistent with the forecasts to the insiders, began to climb (App. B, 7a, *infra*). At one point, the stock was worth $1,600 per share (App. B, 38a, n. 3, *infra*), giving those insiders a profit 200 times the $8.15 purchase price per share. The fantastic rise of IDS stock brought a sharp response from Alleghany shareholders who realized that the corporate portfolio had been raided.

(b) The Prior Derivative Actions

In 1954, derivative actions on Alleghany's behalf were begun in both the state and federal courts, alleging that the proxy material used to solicit shareholder approval of the transaction violated Section 14(a) of the Securities Exchange Act of 1934 and Rule X-14A-9 (App. B, 5-7a, *infra*). These actions sought the return to Alleghany of the IDS shares which the original panel of the Second Circuit has agreed were illegally taken (App. B, 17a, 40a, *infra*). Discovery was commenced in the federal actions where written demand was made upon the insiders for the production of documents, including "forecasts" and "projections" of IDS earnings (App. B, 35a, *infra*). No such documents were produced. Instead, a settlement offer was made (App. B, 7a, *infra*).

(c) The Settlement Proceedings

Although discovery proceedings took place in the federal actions, the settlement offer was presented to the state court

for approval. Kirby, Young and Purcell were proponents of that settlement (App. B, 25a, 29a, 37a, *infra*).

In 1955, the state court appointed Robert Fitzsimmons as Referee to take evidence and report on the fairness and adequacy of the proposed settlement (App. B, 7a, *infra*). At the hearings the Referee explicitly recognized that the issue was the extent of the insiders' knowledge as to future "earning developments of IDS" (App. A, 909a). Counsel for the plaintiffs again specifically demanded documents, including forecasts and projections, which would reveal such inside information (App. B, 35-37a, *infra*). Witnesses, including Young and Purcell, were also pressed for information which would reveal the extent of the inside knowledge (*ibid.*) Over a period of time records were produced (*e.g.*, App. B, 9a, *infra*), but not one of those which revealed the critically important inside information of the forecasts and projections and which were uncovered in the present action (*e.g.*, App. B, 10-12a, 35-37a, *infra*). Counsel for plaintiffs were met with what we now know to be 'emaciated" files (App. B, 36a, *infra*), artful evasions and outright deceit (App. B, 30a; 35-37a, *infra*).

In the meantime an injunction had been issued in the federal court barring the defendants from interposing any state court judgment as a bar in the federal court (App. B, 8a, *infra*).

At the conclusion of the hearings, Kirby, Young, Purcell and Anzalone urged that they "had no inside information from which they could have foreseen [IDS'] subsequent spectacular rise in value" (App. A, 957-58a). With the record lacking the crucial information discovered in the course of this lawsuit (App. B, 35a, *infra*)*, the Referee found that the insiders had no special knowledge or information which would lead them to believe that a spectac-

*See table p. 7, *supra*.

ular rise in the value of the IDS shares was imminent (App. B, 38a *infra*). The Referee's report, therefore, recommended that the state court approve the settlement (App. B, 13a, *infra*).

The state court confirmed the Referee's report (App. B, 14a, *infra*), but the federal district court (Dimock, U. S. D. J.) on September 22, 1959 refused to vacate an order which stood as a bar to settlement (App. B, 15a, *infra*). Following Judge Dimock's decision, Kirby, sought and obtained advice from his counsel as to his potential liability. Spurred by counsel's advice that his potential liability on the IDS stock transaction was in excess of $61,000,000, Kirby authorized new settlement negotiations through defendant Ireland (who became in November, 1959 an officer of Alleghany, (App. A, 179a)) with Phillips acting for plaintiffs (218 F. Supp. at 174).

Under Kirby's authorization, Ireland joined with the settlement offer a private deal for Phillips whereby Phillips would receive a position in Alleghany or IDS paying $45,000 a year for ten years (218 F. Supp. at 177). Phillips refused the bribe and Kirby finally raised his settlement offer to $1,225,000 (*ibid*). The offer was accepted and the next step sought the approval of the new settlement by the district court and the lifting of its injunction (218 F. Supp. at 178).

Since Alleghany had been without independent counsel throughout the negotiation of the settlement agreement (App. B, 48a, *infra*), it was suggested that Ireland, who had negotiated the settlement on Kirby's behalf (App. A, 205a, 180-81a), appear as Alleghany's counsel (App. A, 258a). The suggestion was found acceptable to Kirby (*ibid.*)

The federal district court, like the plaintiffs, was still unaware of the amount of inside information which Kirby,

Young, Purcell and Anzalone had possessed and, of course, unaware of Ireland's dual role. It approved the settlement and lifted the injunction (App. B, 48a, 15a, *infra*).

The defendants then went to the state court and obtained the judgment under attack here (App. B, 15a, *infra*).* The federal court action is still on the calendar. (*Zenn* v. *Anzalone* [S.D.N.Y. Civ. No. 92-205]).**

(d) The Present Action

Shortly after the state court judgment, certain shareholders of Alleghany, including John D. Murchison and his brother, Clint W. Murchison, Jr., received information which led them to believe that Kirby and his representative Ireland had entered into a corrupt bargain with representatives of the plaintiff in order to achieve the settlement which led to the state court judgment. A derivative suit was brought by those shareholders, alleging that fraud (App. B, 6a, 15a, *infra*). Alleghany, still under Kirby's control, elected to actively defend the action (App. A, 9a). Thereafter, an insurgent slate was successful in a proxy contest to oust Kirby from Alleghany's management (218 F. Supp. at 167). For the first time in 23 years Alleghany was free of the control of Kirby and Young and outsiders had access to its files (App. A, 10-11a; App. Int. A, 13b). An examination of those files, as well as those of IDS, which were also available to the management of Alleghany,*** re-

*No notice to stockholders was given at that time. Notice of the earlier settlement had been given but that settlement had been abandoned by all parties and rejected by the federal court.

**Defendants have not tried to dismiss that case, perhaps because notice to stockholders and federal court inquiry under Rule 23(c) would be required.

***Later Kirby's files were also examined and relevant documents not previously produced were also found there (App. B, 11a, *infra*).

vealed the evidence so long concealed (App. B, 10-12a, 33-34a, *infra*). Consequently, Alleghany took over the prosecution of the action and amended the complaint to plead specifically the non-disclosure of inside information as grounds for upsetting the fraudulent settlement (218 F. Supp. at 167).

The amended complaint was tried before a judge, without a jury, in early 1963 and was dismissed (App. B, 23-24a, *infra*).

(e) The Appeal to the Second Circuit

The corporation appealed that decision to the Court of Appeals (App. B, 5a, *infra*). During the period immediately preceding the hearing of the appeal, Kirby had reacquired control of Alleghany (App. B, 50a, *infra*) by purchasing, directly, enough stock to bring his holdings to over 4,000,000 shares, or in excess of 40% of the Alleghany stock (App. Int. B, 11b, 13b). Control of Alleghany, in fact, passed directly into Kirby's hands on the day after the appeal was argued (App. Int. A, 11a).

The original panel which heard this case consisted of Judges Moore, Friendly and Kaufman. That panel split 2-1 in favor of affirmance (333 F. 2d 327 (1964); App. B, *infra*). Judge Moore wrote the majority opinion, Judge Kaufman a concurring opinion, and Judge Friendly wrote a dissent.

The entire panel agreed on three critical propositions:

1. That the 1950 transaction by which Kirby, Young and Purcell acquired the IDS shares was illegal (App. B, 17a, 29a, 40a, *infra*).

2. That the proxy material used by Kirby, Young and Purcell to obtain approval of that transaction was false and misleading (App. B, 17a, 44a, *infra*).

3. That facts and relevant documents were concealed during the course of the settlement negotiations and hearings regarding claims based upon that transaction (App. B, 10-12a, 25-27a, 30-35a, *infra*).

Nor did any member of the panel deny that the settlement ultimately approved by the courts was grossly inadequate (App. B, 19a, 36a, 38a, n. 3, *infra*).*

Despite these substantial areas of agreement on the facts, Judges Moore and Kaufman split with Judge Friendly on the applicable principles of law and denied Alleghany the right to set aside the settlement of the underlying claim. Judge Moore in writing the affirmance for the original panel

(a) held that as soon as a self-dealing director is sued by shareholders, the duty of disclosure ceases; the director becomes an ordinary adversary with no greater obligation of disclosure than that required by court process (App. B, 16a, 20a, *infra*);

(b) held that, although relevant documents were concealed, they weren't material, hence their concealment was insufficient to upset a state court judgment (App. B, 19a, *infra*).

On the other hand, Judge Friendly in dissenting stated that he could "perceive no principle that would eliminate or

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*Judge Moore calculated that "Kirby alone had profited at the expense of Alleghany in an amount in excess of $4,500,000." (App. B, 5a, *infra*). Judge Moore's arithmetic ignored a 5-1 split in IDS stock as well as substantial stock dividends. An accurate account of Kirby's liability is found in Judge Friendly's opinion (App. B, 38a, n. 3, *infra*) which shows Kirby's personal liability to be $22,800,000 and his joint liability over $60,000,000. Kirby settled for $1,225,000 (*ibid.*; App. B, 15a, *infra*), which in his tax bracket cost him only $99,000 (App. B, 38a, n. 3, *infra*).

even lessen the fiduciary obligations of directors who wish to settle a derivative action wherein they are charged with self-dealing" (App. B, 28a, *infra*). He held that Kirby was liable for the concealments of his co-fiduciaries Young and Purcell (App. B, 29-30a, *infra*) (an aspect of the case ignored by Judge Moore) and those concealments were material and hence sufficient to support the setting aside of Kirby's settlement (App. B, 39-40a, *infra*).

Judge Kaufman, in his concurring opinion, did not explicitly agree with Judge Moore as to his view of the absence of fiduciary duty in adversary litigation (App. B, 24a, *infra*), nor did he explicitly reject Judge Friendly's finding that Kirby was liable for the concealments of his co-fiduciaries (App. B, 25a, *infra*). He did, however, adopt Judge Moore's test of materiality, and in doing so, he found the concealments insufficient to upset the state court judgment (App. B, 27-28a, *infra*).

The corporation then petitioned for rehearing *en banc*. That petition was granted by a vote of 4-3 (App. Int. A, 11a), Judges Waterman, Friendly, Smith and Hayes voting for rehearing; Judges Moore, Kaufman and Marshall voting against. (Judge Lumbard abstained and one place on the bench was at the time vacant. After the filing of the principal briefs on rehearing, Judge Anderson was appointed to fill the vacancy.)

On January 12, 1965, the Second Circuit split 4-4 as to the proper disposition of the case; Judges Moore, Kaufman, Marshall and Anderson voting to affirm, and the four Judges who had favored rehearing, voting to reverse (340 F. 2d 311). As a result of that split, the district court's judgment was affirmed.

THE REASONS FOR GRANTING THE WRIT

Review by this Court of the decision below is imperative because:

1. The primary emphasis of federal law governing securities, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, has been in the direction of disclosure. See Fleischer, *"Federal Corporation Law": An Assessment,* 78 Harv. L. Rev. 1146 (1965). Yet the rule applied below rewards nondisclosure. As Judge Friendly observed in his dissent (App. B, 49a, *infra*):

> "This very fact, that directors accused of malfeasance have so much control over the evidence, both documentary and nondocumentary, relating to their misdeed, makes it vital for a court of equity to insist upon a high standard with respect to disclosure at settlement hearings and to subject arguments that a breach was not consequential to a most icy scrutiny."

2. The federal courts have always been sensitive to frauds committed on them, as well as upon their Special Masters. Yet the decision below allows Kirby to keep in his portfolio IDS stock of enormous value through the fraudulent settlement of a claim under Section 14(a) of the 1934 Act. Recognizing the significance of the nondisclosure to the federal court itself, Judge Friendly's dissent pointed out that the nondisclosed evidence (App. B, 39a, *infra*):

> "* * * might have led [District] Judge Dimock to refuse to lift the federal court injunction that had blocked the settlement."

Viewing the situation with his accustomed realism, and defining the proper role of the federal court in cases of this sort, Judge Friendly said (App. B, 48a, *infra*):

> "I cannot see how the attorneys proposing the settlement were any more 'representative' than the attorney opposing it; the stockholders' true representative *was the court*, which was allowed to proceed *in ignorance of vital information.*" (emphasis added)

3. The rule of this case will define the standard of behavior for every director of every publicly held corporation. It will be the guide to every attorney who is called upon to advise his director-clients as to the extent of their duty to disclose prior to settling claims asserted against such directors by the corporation or its shareholders. It will provide federal courts with the tests which they must apply when determining whether such settlements have been honestly procured.

This case, therefore, raises important and urgent questions, none of which have been decided by this court.

(1) The Importance of the Correct Federal Rule.

The threshold question, "Does federal law apply?" is of first importance and is as yet undecided by this Court. We believe that it must be answered in the affirmative.

This case involves a publicly owned corporation whose stock is traded on a national securities exchange.* The underlying claim asserted in this litigation is one under a federal statute, Section 14(a) of the Securities Exchange

*In addition, both Alleghany and IDS are federally regulated corporations. Alleghany, by the ICC (see Pl. Ex. 17, App. A, 688a ¶¶ 52-53) (Alleghany controls the New York Central Railroad) and IDS by the Investment Company Act (Pl. Ex. 17, App. A, 676a, ¶ 19(2)).

Act of 1934. The fraud which led to the challenged settlement of that claim was a shocking non-disclosure which allowed the federal as well as the state court to proceed "in ignorance of vital information." (App. B, 48a, *infra*).

The rule laid down, then, will have national rather than local significance; it will deal with claims created by federal statutes, and with a corporation whose business is of national concern. In such circumstances, the rules as to the fiduciary duties of directors of such corporations should not vary from jurisdiction to jurisdiction. Diverse, perhaps unrealistic, local rules cannot be allowed to govern questions which, by virtue of their broad sweep, require uniform treatment. More important, local rules should not be allowed to govern the settlement of claims made under a federal statute, where the questions raised require resolution by the application of standards consistent with such statutes.* This is especially so where the settlement of the claims required the participation of the federal court.

Of the four opinions in this case (three by Circuit Judges, one by the District Judge), only the trial judge purported to decide anything but federal law (218 F. Supp. at 183-85). Judge Moore looked to federal cases in determining whether the concealed information was material (App. B, 19-20a, *infra*). Treating the duty to disclose, he distinguished federal cases, not because their rules were federal rules, but because he believed they were factually distinguishable (App. B, 21-22a, *infra*). Judge

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*We do not suggest, of course, that this is an area where the legislature has given a mandate co-extensive with that embodied in, for example, federal labor legislation, and that federal courts must create a corpus of law for the entire field which state courts would be bound to follow. We do urge, however, that operating, as the federal courts are in this case, in the penumbra of federal legislation, and in the full light of issues which transcend local considerations, federal courts should apply federal law.

Friendly certainly determined the issues on principles of federal law. See, for example, his treatment of the materiality issue (App. B, 40a, n. 5, *infra*). Without discussion of the choice of law question, the Court of Appeals Judges found their law in federal cases. They were right to do so.*

The important question for this Court, therefore is: (1) Should the duty to disclose, imposed by § 14(a), evaporate completely when the director seeks court approval of the settlement of a claim based on violations of that section? or (2) Should disclosure standards comparable to those deemed necessary by the legislature to protect shareholders at the time of the transactions be imposed by the courts in proceedings brought for violation of the statute? We do not believe it is possible that the duty of disclosure of a self-dealing director who has been challenged in court is somehow less stringent than the duty of the same fiduciary presenting proxy material to shareholders who are being asked to ratify the transaction.**

If this Court finds that equivalent duties exist when the violations are challenged, then the decision here must be reversed, for there is no question that such duties were breached in the course of settlement proceedings in both the

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*Federal courts have in the past indicated that they will look to federal law in determining if a judicially approved settlement should be set aside for fraud by a fiduciary (see *Griffith* v. *Bank of New York*, 147 F.2d 899, 901 (2d Cir.) cert. den. 325 U. S. 874 (1945)).

**It is not our contention that the federal courts must necessarily apply precisely the same standards found in the statute. We do say, however, they should apply standards consistent with the statutory purpose. In doing so the courts may look to the statute, they may look, as Judge Friendly did, to federal cases such as *United States* v. *Consolidated Laundries*, 291 F. 2d 563 (2d Cir. 1961), or to *Hewitt* v. *Hewitt*, 17 F. 2d 716 (9th Cir. 1927), or even to state law. See *e.g. Meinhard* v. *Salmon*, 249 N. Y. 458 (1928). But, wherever they look, they must find and apply rules which will not frustrate the purpose of the statute.

federal and state courts, just as they were in the proxy statements.

Full disclosure is the core of the statutory scheme of stockholder protection. See *Fleischer, Op. cit. supra,* p. 13, at 1148, 1175. We submit that if the courts apply a lesser standard when determining whether settlements of claims brought under those statutes have been fraudulently obtained by continued failure to disclose, the federally created and enforced scheme of stockholder protection would be seriously impaired.

This Court's review of the issues in this case will provide a true definition of director fidelity. It will either provide millions of shareholders with the assurance that they can safely entrust their funds to corporate directors; or it will encourage those directors, so inclined, to abuse their trust, to mislead when challenged and to conceal when sued.

The issue is presented not only at a time when the public is becoming increasingly aware of the opportunities for manipulation and other abuses by corporate insiders, but also at a time when government agencies are bending every effort to put an end to secret profit taking by those insiders.* We respectfully suggest the time has come for this Court to lend its voice to that effort by announcing that directors, *when engaged in self-dealing,* will not be allowed to circumvent the statute by concealment in settlement proceedings, and that the courts will judge their conduct by the same strict standards as those laid down by Congress in the regulatory acts. Such a pronouncement could not be more necessary or more opportune.

The statutory purpose, we believe, was at the base of Judge Friendly's dissent when he stated that the bring-

*Witness the recent Texas Gulf Sulphur action by the SEC.

ing of a suit could not signal the lowering of the standards of disclosure. He said that he could

> "perceive no principle that would eliminate or even lessen the fiduciary obligations of directors who wish to settle a derivative action wherein they are charged with self-dealing. * * * I see no reason why their obligation of fair dealing and full disclosure to a court passing on the settlement should be a whit less than their previous duty to disinterested co-directors and to stockholders." (App. B, 28a, *infra*).

Judge Moore violently disagreed. His view was that when litigation begins,

> "if the defendant-directors were fiduciaries, they certainly were not considered as such by the stockholder-plaintiffs. They were under attack and entitled to defend themselves by all legal means . . ." (App. B, 16a, *infra*).

In essence, Judge Moore held that the duty of full disclosure imposed by the statute upon every director runs only to the commencement of litigation and then evaporates. Although many directors are, of course, honest, the holding will mean that the dishonest ones, running the corporation on the one hand and dealing for themselves with the corporation on the other, will be encouraged to withhold inside information related to the property they are acquiring from the corporation. The less disclosed at any stage of the transaction or in subsequent litigation, the better the odds of getting away with a fraudulent deal. Once successful in maneuvering a settlement through a court, as here, the directors will be allowed, under the rule stated by Judge Moore, to keep the property illegally taken from the

minority stockholders; the very persons Congress and the SEC attempt to protect.

If the decision is not reversed the antiseptic effect of § 14(a) will be diluted by a judicial invitation to faithless directors to conceal. One regrettable consequence of Judge Moore's view is that while it certainly gets litigation out of the courts, it also creates a weak link in the disclosure requirements so fundamental to the whole scheme of federal securities regulation.

Judge Friendly's view, that it is "vital for a court of equity to insist upon a high standard with respect to disclosure at settlement hearings and to subject arguments that a breach was not consequential to the most icy scrutiny" (App. B, 49a, *infra*), is a view more consistent with the statutory purpose and the role of the federal courts in litigation of this sort. It is more likely to insure that repetitions of self-dealing of the kind involved here—which even Judge Moore found to be illegal (App. B, 17a, *infra*)—will not be repeated. It will also insure a just result in cases when directors do, in spite of their duties and in spite of the law, grossly abuse their trust.

It may be argued that business morality cannot be legislated and that it is not the Court's role to try to enforce such morality. We disagree. In a society in which so much wealth and power rests in the hands of corporate directors, business morality is not only a legitimate, but also a pressing concern for both our legislature and our courts.

(2) This Court Should Review Because of the Important Issue Posed by the State Court Judgment.

A question of prime importance to the relationship between the federal and state courts is also posed for review: Should the existence of a state court judgment approving a

settlement bar a federal court from applying its standards and setting the judgment aside?

The trial court ignored federal standards, believing that *Erie R. Co.* v. *Tompkins,* 304 U. S. 64 (1938) and the existence of a state court judgment required it to apply the New York rule concerning intrinsic fraud (218 F. Supp. at 183-84). Accordingly, it held that the fraud was not of the variety which allowed a New York court to set aside a previous judgment in a collateral attack (218 F. Supp. at 184-85). We believe that the trial court's approach was plainly incorrect. Under the circumstances of this case, the federal court was not obliged by *Erie R. Co.* v. *Tompkins* to apply New York's intrinsic fraud doctrine.

The Circuit Court avoided this error. Neither the majority, the concurring, nor the dissenting opinion expressed the belief that *Erie R. Co.* v. *Tompkins* required the application of state law to the issues in this case.* Judge Kaufman's concurring opinion, however, contained a similar misconception. He thought that because of the existence of the state court judgment "considerations of *res judicata* and comity must be taken into account; institutional imperatives and the necessity of finality in litigation are of far greater significance" (App. B, 27a, *infra*) than finding and applying the correct federal standard.

But the doctrine of res judicata has no application here. The issues raised by this case, fraudulent concealment from federal and state courts, have never been tried. Where fraud is alleged as a basis for setting aside an earlier judicial determination, *res judicata* does not come into play.

Nor do we believe that comity requires that federal courts abandon standards necessary to prevent a state court

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*Nonetheless, the 4-4 split, which resulted in affirmance of the trial court's judgment, has left the law on this question in a confused condition.

judgment from subverting a federal statute and to protect its own courts from fraud.

Moreover, we believe that there are no "imperatives" as compelling as those which argue for the application of the correct federal standard. Putting aside the necessity for a just result (a not insignificant imperative in itself), the considerations set forth above, taken together with those at the conclusion of Judge Friendly's dissent, provide urgent reasons for this Court to review and to reverse the decision below.

Nor can the trial court's decision be justified by invoking the specter of continued litigation. No one would deny that a rule which calls a halt to litigation in the proper circumstances has a useful place in our judicial system. But it is not the only consideration.

When shareholders are victimized, they will come to the courts seeking redress. Judge Kaufman and Judge Moore would limit those suits by rules which would discourage such litigants from pursuing their rights if proof of the wrong is discovered only after they have once settled with the wrongdoers. Perhaps such a rule would deter some litigants. There is no certainty, however, nor should there be, that those who find their trust has been abused, will forego an attempt, or even a second attempt, to bring to justice those who have defrauded them.

This court should review this case and, we believe, adopt the view proposed by Judge Friendly. That view would attempt to prevent litigation, not by discouraging the victim, but by discouraging the victimizer. It would set up standards of conduct that will prevent the abuse of trust, and it would sound a clear warning to those who did not abide by those standards that they will be made to disgorge their gain.

(3) This Court Should Review to Correct the Erroneous Judgment of the Trial Court Even if the Issues are Controlled by State Law

If this Court decides that state and not federal law controls the issues, a third question arises: If the state law was erroneously applied are the issues here of sufficient importance for this Court to review and reverse? The importance of this question does not lie simply in the fact that even by state standards the lower court reached the wrong result. It lies in the effect that the erroneous decision of the trial court will have.

Even if state law is deemed to control, this case will still involve a national, publicly held corporation. It will still determine whether a federal court will set aside a state court judgment when the federal court, as well as the state court, was victimized by fraud. It will still make law in an area of nationwide importance. It will still set a standard of conduct and lay down a rule for dealing with breaches of that standard which will guide the behavior of vast numbers of directors. In short, the importance of the rule of this case will not be diminished by the fact that it is couched in terms of state rather than federal law.

In *Perlman* v. *Feldmann*, 219 F. 2d 173 (2d Cir.), cert. den. 349 U. S. 952 (1955), a landmark case in the law of directors' fiduciary duties, the Second Circuit looked, in the first instance, to the law of Indiana. It would be difficult to deny, however, that the decision in that case made anything but federal law. The rule of *Perlman*, today, is the rule of national corporation law, not merely Indiana law.

So, too, if for no other reason than the amount of corporate litigation which passes through the New York courts and the respect afforded their decision in that area, this case will become the guide for all corporate directors.

(4) The Independent Fraud on the Federal Court.

An additional issue of federal importance arises out of an independent fraud on the federal court which passed on the settlement attacked by this suit. Alleghany, at that time, was purportedly represented by Charles T. Ireland, Jr., who, until the eve of his appearance in court as Alleghany's counsel had represented the defendant, Kirby, in the settlement negotiations. As Kirby's representative, it was his job to secure a settlement as profitable for Kirby and as unprofitable for Alleghany as was possible. As Alleghany's counsel it was his job to examine the settlement and tell the court if he believed that it was as fair a settlement as his client, Alleghany, could receive. The record shows he took his former job more seriously. In pursuit of Kirby's interest, the trial court found that he had offered a bribe to the plaintiff's representative (218 F. Supp. at 177). In representing Alleghany he allowed the court to approve a settlement which Kirby knew, and Ireland should have known, to be inadequate.

The law requires that in actions of this sort, the corporation be represented by independent counsel whose interests will not conflict with those of the defendant. *Lewis* v. *Shaffer Stores Co.*, 218 F. Supp. 238, 240 (S. D. N. Y. 1963), *Garlen* v. *Green Mansions, Inc.*, 9 A. D. 2d 760, 193 N. Y. S. 2d 116, 117 (1st Dep't. 1959); see Note, *Independent Representation For Corporate Defendants in Derivative Suits*, 74 Yale L. J. 524. It is hard to conceive of counsel for Alleghany who would fall shorter of that standard than Charles T. Ireland, Jr.* We submit that had the district court been told of Ireland's true role it would not

*Upon reacquiring control of Alleghany, Kirby made Ireland President of Alleghany at a salary of $100,000. (App. Int. A, 12a, 12b).

have approved the settlement. Therefore, the concealing of that role is a sufficient fraud, in our view, to require a federal court to set aside a judgment so procured.

(3) The Jurisdictional Issue.

If this writ is granted petitioners will also raise a jurisdictional issue, which arises as a result of this court's decision in *J. I. Case* v. *Borak*, 377 U. S. 426 (1964). The *Borak* case, in our view, compels a determination that the state court had no jurisdiction over the exclusive federal claim asserted in the derivative actions whose settlement is attacked by this suit.* The entire bench of the Court of Appeals, however, rejected this contention because it had been raised in the state court in the course of the prior derivative litigation and because an adverse decision by the state court had not been appealed to this Court.** The soundness of that view raises an important question as to the exclusive jurisdiction of the federal courts.

The *en banc* decision of the Court of Appeals cited *Treinies* v. *Sunshine Mining Company*, 308 U. S. 66, 78 (1939) in support of its holding. *Treinies*, however, did not say that a federal court cannot review, in a collateral action, a determination by a state court that it had jurisdiction over an exclusive federal claim. That case merely said that it would not inquire into the propriety of the determination by a state court that a sister state had no jurisdiction over the matter in issue.

This error by the Court of Appeals in a developing area of the law, is of sufficient importance to require review by this Court.

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*See § 27, 15 U. S. C. § 78aa.

**The Court of Appeals indicated there were other reasons for rejecting this contention, but they did not specify what they were. (340 F. 2d at 312, n. 1).

(6) The Final Reason for Granting the Writ: The 4-4 Split.

The even division of the Court of Appeals "as to the proper disposition of the case" (340 F. 2d at 312) provides, we believe, a compelling argument for granting this petition for three reasons:

1. The failure of the judicial process to resolve an issue is in itself reason for granting the writ. This Court in the past has not tolerated the failure of Circuit Courts to resolve an issue.

In 1802 Congress created, and this Court subsequently approved, the "certificate of division" to avoid the final determination of cases by a split decision. In holding that such device was designed to meet the problems caused by a split bench and was not obviated by the act creating circuit judges, this Court stated:

> "That difficulty [i.e., a split bench] arose from the fact that the court was constituted of two judges, between whom a difference of opinion would be likely often to occur, and thus block the wheels of justice. . . . This renders it desirable, when a court consists of the former number, to have some method provided for overcoming the intrinsic difficulty." *New England Mar. Ins. Co.* v. *Dunham*, 78 U. S. (11 Wall.) 1, 21-22 (1871).

The Court's rationale is applicable here.

Similarly, when an original panel could not agree, as in *Civil Aeronautics Board* v. *American Air Transport, Inc.*, 344 U. S. 4, 5 (1952), or when two panels of the same court disagreed, as in *Wisniewski* v. *United States*, 353 U. S. 901, 902 (1957), this Court suggested an *en banc*

hearing to prevent a "decision" which did not resolve the issue.

Here, it is the split bench on the *en banc* rehearing which has "blocked the wheels of justice." We submit, that this Court should grant the writ to remedy that failure.

2. The failure to resolve the issue here is particularly urgent (a) because of the wide effect of the issues raised here, and (b) because the federal courts in the Second Circuit handle a large volume of litigation in which this issue may arise, and, hence, are in special need of guidance in this area. As matters now stand district judges in the Second Circuit, unless they know which three of the Circuit Judges will review their decisions, will not know whether they will be reversed or affirmed.

3. The failure here is important because guidance is needed not only by the district courts but by directors of publicly held corporations. In the present posture of the case neither those directors nor their attorneys have a proper guide to what the duties of a director are.

Finally, the split reveals a deep division in the Court of Appeals, not only as to the rule in this case, but also as to the proper approach to all cases involving the duties of directors (see, for example, *Brown* v. *Bullock*, 294 F. 2d 415 (1961)). This split, which apparently arises out of fundamentally divergent views of the law and will manifest itself repeatedly in this important class of litigation, can only be resolved by this Court.

CONCLUSION

For the reasons given, we respectfully pray that the writ be granted.

STUART N. UPDIKE
Attorney for Petitioners

J. HOWARD CARTER
LEE W. MEYER
RONALD S. DANIELS
RICHARD J. BARNES

May 12, 1965

APPENDIX A

Per Curiam Decision of Court of Appeals *En Banc*

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 154—September Term, 1964.

(Submitted November 9, 1964 Decided January 12, 1965.)

Docket No. 28397

ALLEGHANY CORPORATION,

Plaintiff-Appellant,

v.

ALLAN P. KIRBY, CHARLES T. IRELAND, JR., and FRED M. KIRBY,

Defendants-Appellees,

RANDOLPH PHILLIPS,

Defendant.

Before:

WATERMAN, MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS, MARSHALL, ANDERSON,

Circuit Judges.

Appendix A

On Rehearing

TOWNLEY, UPDIKE, CARTER & RODGERS (Stuart N. Updike, J. Howard Carter, Lee W. Meyer, Ronald S. Daniels, Richard J. Barnes, Peter G. Kelly, of counsel), New York City, *for Plaintiff-Appellant.*

DONOVAN LEISURE NEWTON & IRVINE (Granville Whittlesey, Jr., James V. Hayes, Robert M. Loeffler, Walter L. Stratton, John J. McCann, Ben Vinar, of counsel), New York City, *for Defendants-Appellees.*

PER CURIAM:

Subsequent to the filing of the three opinions in this case on May 19, 1964, reported at 333 F. 2d 327, plaintiff-appellant petitioned for a rehearing by the full court. This petition was granted on July 22, 1964, Chief Judge Lumbard disqualifying himself and not participating. Later, the court having ordered that the rehearing be without oral argument, briefs were submitted by the parties, the last and final brief in rebuttal having been filed on November 9, 1964.

Upon consideration of the petition and subsequently filed memoranda, the court is evenly divided as to proper disposition of the case, for Judges Moore, Kaufman, Marshall

and Anderson would affirm the decision below, reported at 218 F. Supp. 164 (S. D. N. Y. 1963, Dawson, *J.*) and Judges Waterman, Friendly, Smith and Hays would reverse that judgment and would remand the case to the district court for further hearing there.[1]

Accordingly, the judgment below is affirmed.

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[1]In its reply brief on rehearing *en banc* appellant points out for the first time that since the claim in the state court suit relating to the exchange of stock was grounded in part on an allegedly false and misleading proxy statement, see § 14(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78n(a) and SEC Rule X-14A-9, federal jurisdiction existed, see *J. I. Case Co.* v. *Borak*, 377 U. S. 426 (1964), and argues that § 27 of the 1934 Act, 15 U. S. C. § 78aa, made such jurisdiction exclusive and rendered the state judgment void. We find it unnecessary to rule on the argument. For, apart from any other factors, the issue of jurisdiction was raised in and decided by the New York courts, 1 App. Div. 2d 662, 146 N. Y. S. 2d 213 (1955), motions for reargument and for leave to appeal to the Court of Appeals denied, 1 App. Div. 2d 773, 149 N. Y. S. 2d 213 (1956); and no attempt to secure review by the Supreme Court of the United States was made. See *Treinies* v. *Sunshine Mining Co.*, 308 U. S. 66, 78 (1939). On this the court is unanimous.

APPENDIX B

Opinion of the Three Judge Panel

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 173—September Term, 1963.
(Argued December 2, 1963 Decided May 19, 1964.)
DOCKET No. 28,397

ALLEGHANY CORPORATION,
Plaintiff-Appellant,

—against—

ALLAN P. KIRBY, CHARLES T. IRELAND, JR., and FRED M. KIRBY,
Defendants-Appellees,

RANDOLPH PHILLIPS,
Defendant.

ARGUED DEC. 2, 1963.

DECIDED MAY 19, 1964.

PETITION FOR REHEARING EN BANC GRANTED JULY 22, 1964.

Opinion of Judge Moore

Before MOORE, FRIENDLY and KAUFMAN, Circuit Judges.

MOORE, Circuit Judge:

For some ten years, the subject matter of the lawsuit now on appeal has been before the New York State and

federal courts. The particular aspect now presented is an appeal from a judgment in an action in the district court wherein plaintiff (appellant), Alleghany Corporation, sought to set aside, as obtained by fraud, a settlement of stockholders' derivative actions. Alleghany Corp. v. Kirby, 218 F. Supp. 164 (S.D.N.Y. 1963). This appeal is further limited to the claim that the settlement was obtained by defendant (appellee Allan P. Kirby), as a result of his failure voluntarily to disclose upon the settlement certain facts, essential to a proper adjudication of the fairness and adequacy thereof, alleged to have been known to him at that time. The district court found adversely to appellant.

The transaction giving rise to the many suits originated on December 6, 1949. On that date four officers and directors, including defendant Kirby, voted illegally (so alleges plaintiff) to give themselves an opportunity to exchange Alleghany preferred stock held by them for Alleghany's entire portfolio holdings of 48,225.61 shares of Class A stock of Investors Diversified Services, Inc. (IDS). Pursuant to a December 6, 1949 resolution authorizing an exchange, Kirby tendered his Alleghany preferred stock to Alleghany and Alleghany, in turn, transferred 24,062 shares of IDS stock to Kirby at a price of $8.1453 per share.

By 1954 the price of the IDS stock had advanced to some $200 a share. At such a price Kirby alone had profited at the expense of Alleghany in an amount in excess of $4,500,000. Champions on behalf of Alleghany did not long remain on the sidelines and soon (1954-55) many derivative suits were commenced in both state and federal courts. Other similar suits were brought in the federal court. In accordance with a practice which had developed in the State court to avoid complete chaos amongst the

many would-be champions, under the caption of Zenn et al. v. Anzalone et al., Sup. Ct., N.Y.Co., 17 Misc. 2d 897, 191 N.Y.S.2d 840 (referred to as the Zenn suits), the ten suits were consolidated and a general counsel (Abraham L. Pomerantz of the firm of Pomerantz, Levy & Haudek) was designated for the plaintiffs in the state and federal suits. Such counsel and his firm were most skilled and experienced (at least for over twenty years) in ferreting out fraud on the part of directors alleged to have been more mindful of serving their own interests than those of the corporations whose interests they should have been serving.[1] Naturally the complainants in the various suits turned their spotlights on the IDS stock exchange and the fact that the beneficiaries thereof knew of, or were in a position to know of, the enormous prospective increase in earnings of IDS.

More specifically, the consolidated amended complaint (First Cause of Action) alleged that Kirby, Robert P. Young and other named co-defendants were engaged in a conspiracy "to enable defendants Young and Kirby to enrich themselves at the expense of Allegehany"; that the IDS stock exchange was to be made at Alleghany's cost or the market price determined as of the final exchange date whichever was higher and "was to be conditional upon ratification by Alleghany's common stockholders at their annual meeting on May 3, 1950"; that the proxy statement was "false and misleading with respect to material facts

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[1]In Heddendorf v. Goldfine, 167 F. Supp. 915, 920 (D. Mass. 1958), the court said: "Moreover, Mr. Pomerantz's judgment as to the value of so much of the claims as fall within the first four categories of the complaint is a judgment not only based on painstaking preparation but also reflecting an almost unparalleled experience in this type of litigation. * * * His support of the compromise embodies the pragmatism of a man whose shrewdness few antagonists have ever doubted."

and omitted to state material facts necessary to make the statements therein not false or misleading," in part, including a failure to reveal not only an actual increase in earnings for the first three months of 1950 (i. e., $2.17 per IDS share, projected as $8.68 on an annual basis) but also a trend to further improvements "foreseeable to and foreseen by the individual defendants"; that 1950 earnings amounted to $20.76 a share; that the earnings trend was reflected in a spectacular increase in market value (also "foreseeable to and foreseen by") to $28, $37.75, $89.50, $100 at the end of the respective years 1950-53 and about $200 at the date of the complaint; that even at the date of the exchange (May 15, 1950) Kirby failed to pay the required consideration in that he paid $148,273.79 less than called for by the respective market prices of Alleghany preferred Series A and IDS stock; and that as a result of such fraud both the exchange and the purported stockholder ratification were void.[2] Rescission or the difference in value between the price paid and the real worth of the IDS stock was demanded. Kirby, although named as a defendant in the state court suits, actually was not served with process therein.

As not unusual in this type of suit, settlement negotiations soon began and in July 1955 a settlement stipulation in the Zenn suits was drafted. Alleghany thereupon moved in the New York Supreme Court for approval of the settlement. A Referee was appointed by the court to inquire on the merits into the fairness and adequacy thereof. Under New York practice, notice of the terms of the proposed settlement was sent to all stockholders and hearings commencing in September 1955 were held before the Referee.

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[2]Similar charges were made in the "Second Count" of the consolidated amended complaint in the federal court Zenn suit, Civ. No. 92-205, S.D.N.Y.

Appendix B

Opinion of Judge Moore

In February 1955 a suit had been brought in the federal court in New York by another group of stockholders entitled Breswick v. Briggs, S.D.N.Y., 135 F. Supp. 397. Although some of the charges made were similar to those in the Zenn suits, the 1950 IDS stock exchange was not placed in issue.

The Breswick plaintiffs had not been participants in the Zenn settlement negotiations. For this reason and lest they be bound by any settlement therein, they sought and obtained in October 1955 a federal court injunction against the interposition of any defense based upon any settlement agreement not negotiated with them.

Returning to the hearings before the Referee in the Zenn action, there was vigorous opposition to the settlement. Many of the arguments now advanced were urged as reasons for rejecting the settlement. Counsel (Seymour Graubard of Graubard & Moskovitz) for one objectant (Rosen) in particular worked in close association with counsel in Breswick. The statistics as to the nature and duration of the hearing are revealing. Eighteen witnesses were called, some 480 exhibits introduced, over 4,600 pages of testimony were taken and twenty-two law firms and attorneys appeared. The hearing on the merits of the settlement was, in effect, a hearing on the merits of the suits.

The primary issue in the first cause of action in the Zenn suits was whether Kirby knew or should have known that the IDS stock, which he obviously had acquired from Alleghany in a self-dealing transaction, was worth far more than he paid for it. Counsel for Alleghany, to establish such knowledge and a logical imputation thereof, sought to and did by pre-trial procedures delve into the files of Alleghany and IDS for proof.

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The Referee characterized the hearings as "truly an adversary proceeding, more nearly resembling a trial on the merits than a hearing on a proposed settlement * * *" He accurately perceived the principal issue, namely, Alleghany's claim that the defendants had failed adequately to reveal to the stockholders "the alleged sharp upward turn in the profits of IDS and the further improvement of future earnings which it is claimed was foreseen by Young, Kirby and Purcell."

Before considering the facts which appellant claims were not before the Referee, the alleged concealment of which forms the basis of its argument that the settlement was tainted with fraud, it would be well to review briefly certain items of proof before the Referee which bore upon Kirby's then (December 1949 through May 1950) knowledge or which might reasonably have put him on notice of substantially increasing earnings.

In February 1950, Robert W. Purcell had written Young and Kirby advising them of a net income before home office expenses forecast for the IDS mortgage department alone of $5,720,000 for 1950 in contrast with $2,277,000 for 1949. Kirby was told that this estimate was said to be "very conservative" and that mortgage department "operations promise to show continued substantial earnings." Had Kirby inquired at the end of the first quarter of 1950 as to net income, he would have learned of an income figure of $639,040 instead of a corresponding 1949 first quarter loss of $1,298. Purcell's optimism for 1950 was justified by a net income for 1950 of $6,454,411 instead of $1,365,485 for 1949. In addition, the Referee had the actual net income figures for the years 1949-1953 as contained in the IDS annual reports which showed a steady increase from $374,355 in 1948 to $13,229,310 in 1953.

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During the trial in the district court, Alleghany caused to be produced certain documents which were not before the Referee and claimed that Kirby's failure to adduce them on the settlement hearings prevented the Referee from properly evaluating the fairness and adequacy of the proposed settlement under consideration. Of the "non-disclosed" documents which Alleghany claims were of critical significance, it stresses the following:

A. *The Froggatt Report of April 29, 1949.*

This report was addressed to the IDS Board of Directors and was primarily concerned with a valuation of IDS certificates in force as of December 31, 1948. In addition, a prognostication was made for the years 1949-53 of net income available for improving certificate reserves before profit or loss on sale of investments or income taxes. Kirby apparently had received this report in August 1949. It was mentioned in an exhibit introduced before the Referee and was later found in Alleghany and IDS files.

B. *An IDS Projection of Net Income for the Years 1949-53 Before Profit or Loss From Sales of Investments and Income Taxes.*

There was no evidence that Kirby had received these figures.

C. *An IDS Projection of Net Income for 1950 Through 1954 and a Projection for 1950 by Months.*

These projections produced from the IDS files in discovery proceedings were not admitted in evidence by the district court because there was no evidence that Kirby had ever had them in his possession or that he knew of them.

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Nor was there any showing that counsel in Zenn had been in any way precluded either in pre-trial or in the settlement hearings from seeking any and all papers in the possession of IDS. To the contrary, there was proof that during the hearings before the Referee (1954-1958) documents in the IDS files were available upon request.

D. *The Purcell Letter to Young Dated July 27, 1954, With Enclosures.*

On July 27, 1954, Purcell sent to Young a letter from Waag, Vice-President and Controller of IDS, with certain documents obtained from Waag. The statement entitled "Comments on Operations December 1950" compares IDS' financial situation as of December 31, 1950 with the same date in 1949. 1950 income is stated as $6,142,232 in contrast to 1949 income of $1,078,272. However, this statement must have been prepared subsequent to December 31, 1950, and hence not available prior to the consummation of the exchange. The district court excluded this exhibit. Another statement disclosed net income for 1949 and 1950 by quarters. Although excluded by the district court, this statement had been introduced in the Zenn hearings and showed an increase in net income from $1,365,485 in 1949 to $6,454,411 in 1950. The third statement set forth a 1950 quarterly analysis of some of the larger housing project items in which IDS had participated. This statement, although not received below, had also been admitted in the Zenn hearings.

In summary, most of the allegedly "non-disclosed" documents came from Alleghany or IDS files. In some instances, copies were produced from Kirby's files. The fact that IDS prepared projections could not have been unknown

to Alleghany counsel in Zenn because the April 7, 1949 Shipman report contained a ten-year (1947-1956) IDS earnings projection. Other documents did not come into existence or into Kirby's possession until after the stock exchange had been consummated. As to the documents which Kirby received, he was chargeable with all the legal consequences of such information; as to those excluded by the district court on the ground that there was no evidence that Kirby had seen them, there is no basis for holding this finding of fact to be clearly erroneous. Furthermore, the district court had in the record before him evidence virtually identical to that contained in the documents excluded by him, particularly with relation to compilations of projected earnings. The earnings projections would undoubtedly have been useful in cross-examining Kirby before the Referee as to the extent of his belief with respect to future earnings. However, Kirby was not called as a witness and, therefore, there was no occasion to cross-examine.

As a result of the federal court's suggestion in Breswick, the defendants in Breswick, including Kirby, engaged in their own settlement negotiations. These were productive of an increase in the Zenn offer, from $7[illegible]00 cash to $1,000,000 plus certain other benefits. However, the Breswick plaintiffs still were not satisfied. The Breswick defendants then moved to vacate the injunction which for practical purposes was standing in the way of the Zenn settlement. The federal court thereupon appointed the Zenn Referee as a Special Master to hear and report on the good faith of the Breswick settlement proposal. Hearings were held in October and November 1956 and 675 pages of testimony were taken.

In June 1958 the Referee reopened the Zenn State court hearings to receive the increased offer and in November

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1958 handed down his report of some 125 pages approving the settlement. Thereafter exceptions to the report were filed on behalf of the stockholder Rosen objecting to the settlement. The Referee's report was attacked as ignoring and glossing over the evidence that tended to establish liability. The court was urged to "scrutinize the evidence and examine the law" and then withhold approval of the settlement. In the brief opposing approval, the objectant presented virtually all the arguments now advanced by appellant, namely, (1) the possession of inside knowledge by Kirby and Young that the earnings of IDS would increase approximately 500% for 1950 alone; (2) the illegality of the meeting of December 6, 1949 authorizing the exchange offer; and (3) the failure to disclose material facts to the stockholders and the falsity of facts disclosed in the proxy statement for the meeting of May 3, 1950 at which the exchange was ratified. The law relating to self-dealing on the part of directors, their fiduciary position, the legal effect of inside knowledge, the invalidity of the defenses of ratification and laches because of fraud, was also placed before the court.

In support of these arguments, the objectant had facts, leads and clues from which to draw the conclusion that Kirby knew or should have known of the speculative potential in the IDS shares. From the outset in 1948 when Alleghany was considering the acquisition of the voting and Class A (non-voting) stock of IDS, Kirby, Young and their associates were aware of the IDS financial picture. Kirby desired to be kept fully informed. This desire was fulfilled by oral and written financial reports. Specifically, Kirby was advised (if he did not already know) by Purcell's letter to him and Young dated February 11, 1950,

that there was enough additional mortgage business on the IDS books in 1949 to add some $5,500,000 to IDS's 1950 earnings. The prophecies envisioned were soon realized. Even before the stock exchange was consummated in May, 1950, the first quarter earnings of $631,000 against a loss of $223,000 for the corresponding quarter of 1949 were available. And had any counsel desired to inquire of Kirby himself not only as to his then knowledge but as to his state of mind regarding IDS and its future, all legal processes were at their command to make such inquiry. Even forecasts were known to have been made. Graubard in his testimony specifically mentioned forecasts and said that "my briefs to the Referee and Judge McGivern lay stress upon these forecasts." He had "a particular recollection indeed of mention of these forecasts in correspondence between Mr. Purcell and Mr. Young." Furthermore, Graubard argued in Zenn that the letter vividly demonstated that "Purcell was able early in February 1950 to predict with uncanny accuracy the extra five million in mortgage department earnings of IDS for the entire year 1950."

The Supreme Court confirmed the Referee's report, saying in part that "Every proposed settlement in this type of litigation constitutes a compromise in which each of the parties expects to make some surrender, in order to prevent costly and protracted litigation," and concluded that "In sum, after consideration of all of the factors in this case, this court is of the opinion that the original stipulation of settlement herein, as now augmented by the latest subsequent offer of defendants, is fair and reasonable, was negotiated at arms' length, is free from fraud or collusion and is in the best interests of the Alleghany Corporation and its stockholders." Zenn v. Anzalone, 17 Misc.2d 897,

898, 899-900, 191 N.Y.S.2d 840, 843-844 (Sup.Ct.1954). However, because of the existence of the injunction in the Breswick suit in the federal court, the New York court directed that no order be entered until the injunction was vacated.

Thereafter, the federal court rejected the report of the Referee (Special Master in Breswick) which recommended that the injunction be vacated. At this stage further settlement negotiations were renewed which resulted in an offer by Kirby satisfactory to court and counsel in the Breswick suit. A supplemental stipulation of settlement in the Zenn action was thereupon executed, providing for the payment by Kirby of $1,100,000. The Young Estate agreed to contribute an additional $900,000 to the basic Zenn settlement. Thus, Alleghany received $3,000,000 cash and return of control of IDS to Alleghany by the Murchison Brothers. The federal court injunction was thereupon vacated and towards the end of December 1959 orders of the Supreme Court, New York County, were entered, approving the settlement.

Appellant in this action originally attacked the settlement upon two grounds: (1) that Kirby obtained a favorable settlement for himself in the negotiations of October, November and December 1959 by inducing the defendant Randolph Phillips to betray alleged fiduciary duties to Alleghany for personal benefits promised to him by Kirby, and (2) that Kirby had failed to adduce before the Referee and the state court facts material to a proper evaluation of Kirby's liability on claims arising out of the 1950 IDS stock exchange transaction.

The district court found that appellant had failed completely to establish any fraud in which Kirby and Phillips were involved in connection with the ultimate settlement.

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No appeal has been taken from this finding. There remains for consideration whether Kirby's alleged failure to produce certain records before the Referee in the state court Zenn action under the circumstances provides a basis for a federal court setting aside the settlement and, in effect, trying the case *de novo* on the merits despite the settlement.

The theory behind allowing a stockholder to bring a derivative stockholders' action rests upon the belief that wrongdoing directors will not voluntarily sue themselves or willingly admit their wrongful acts; hence, the right to bring a suit on behalf of the corporation is given to a stockholder. Here there were ten such suits. At this stage, if the defendant directors were fiduciaries, they certainly were not considered as such by the stockholder plaintiffs. They were under attack and entitled to defend themselves by all legal means including the right to require the plaintiffs to prove the charges made. They were, of course, under a duty to respond to all subpoenas, upon proper demand to produce all records in their possession, and to testify if called as witnesses. In the Zenn suit Kirby, although named as a defendant had not been served. He had not been subpoenaed or served with a notice to produce records in the suit itself or in the proceeding before the Referee. Nor did he testify before the Referee. Control of Alleghany's interests so far as the 1950 IDS stock exchange was concerned was in the hands of competent counsel in the derivative suits on behalf of Alleghany who had available to them all the procedural processes designed for effective pre-trial preparation. Kirby and his co-defendants were in no position to force a settlement upon the Zenn plaintiffs. These plaintiffs could have insisted upon a trial. Had they prevailed, the damages according to the theory adopted by the court could have ranged from modest amounts to astro-

nomical figures. But even fraud cases can often be settled. A settlement is the price of peace. There is no prerequisite to the settlement of a fraud case that the defendant must come forward and confess to all his wrongful acts in connection with the subject matter of the suit. Usually such settlements are accompanied by vigorous denials of any fraud whatsoever. Yet the entire thrust of appellant's argument on this point is, in effect, directed to a proposition that Kirby was under some affirmative duty to come forward voluntarily with facts and documents possibly disclosed for the first time in this suit and of which he may or may not have had knowledge.

There can be no question that the exchange transaction perpetrated by Kirby, Young and Purcell violated fundamental legal principles against self-dealing. If the purchase of IDS was thought to be advantageous for Alleghany over a period of years, there was no justifiable reason for these officers to take this advantage away from the corporation to which they owed fiduciary duties. Nor can there be any question that the proxy statement on the basis of which stockholder ratification was sought was misleading, both in its statements and particularly in its omissions. Thus, the illegality of the exchange, the deception practiced upon the stockholders, the falsity of the Kirby statement as to the date of the exercise of the exchange offer, knowledge, either actual or imputed, of the very substantial increase in IDS earnings, the actual history of the earnings and market price of IDS stock over the period from 1950 to 1955, all these facts were available to the Zenn plaintiffs and were the basis of the charges in the stockholders' complaint. To counsel who now represent Alleghany these are "shocking facts," but they probably were equally shocking to the counsel who then were responsible for Alleghany's welfare.

Alleghany could have submitted these facts to the court for determination on the merits. Through its representatives, it elected to settle. The requirement that settlements of derivative suits be upon notice to all stockholders and be subject to court scrutiny and approval was a further protection. If the settlement were approved over stockholder objection, as here, such stockholder had a right to appeal to the Appellate Division of the Supreme Court and under certain circumstances to the New York Court of Appeals. The objecting stockholder here did not exercise such rights. Having failed to pursue its remedy along normal channels, Alleghany by this action sought to have a federal district court act, in effect, in an appellate capacity to review the decisions of the Referee and the New York Supreme Court. It does this upon its theory that it has discovered certain documents which, if produced before the Referee and Supreme Court would have induced them to have disapproved the settlement.

The wrongful conduct of Kirby and his associates formed the entire basis for the Zenn suits. The Referee and the counsel for the complaining stockholders were not kept in ignorance of the facts. If their searches, aided by pretrial discovery, did not uncover certain documents, if their inquiries fall short of obtaining the documents now brought forth by Alleghany's present counsel, or if in their judgment various documents were not introduced into evidence, these circumstances do not justify the setting aside of a settlement satisfactory to those in charge of the suit in behalf of Alleghany. Particularly is this true in the light of the bitter attack upon the settlement by the objecting stockholder. Were every settlement which had been carefully examined and judicially approved to be vacated at the behest of some subsequent corporate champion who brings forth certain

documents which he claims might have so influenced the court that the settlement might not have been approved, there would be no finality to any litigation whether by settlement or by judgment.

By *a fortiori* analogy, the evidence said to have been "non-disclosed" or concealed should at least be of the character required for a new trial, namely, would it "probably have produced a different result." Helene Curtis Inds. v. Sales Affiliates, 131 F.Supp. 119, 120, aff'd 233 F.2d 148 (2d Cir.), cert. denied, 352 U.S. 879, 77 S.Ct. 101, 1 L.Ed.2d 80 (1956). So much stronger should be the evidence of fraud where a collateral attack is being made in a federal court on a state court judgment which the parties thereto did not even challenge by resorting to state appellate proceedings. Examination of the "non-disclosed" documents leads to the conclusion, also reached by the district court, that although the documents would have been admissible had they been offered before the Referee, they do not form a basis for "collaterally attacking a judgment rendered after trial or a release given pursuant to the judgment." 218 F.Supp. at 186. At most they would have been but cumulative evidence upon the basic issue of Kirby's fraud in acquiring IDS stock at a grossly inadequate price. But this fraud gave rise to the stockholders' suit and for this fraud he paid the settlement price. It is this price with which Alleghany's present counsel is dissatisfied. However, as long as there are lawyers there will be expressions of honest belief that better settlements could have been obtained had subsequent counsel been in charge initially.

Alleghany makes much of our decision in United States v. Consolidated Laundries Corp., 291 F.2d 563 (2d Cir. 1961), as supporting its argument that it was not for the trial judge here to speculate concerning the effect which the

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"non-disclosed" documents might have had or the Referee or the Court which confirmed the report. The situation in Consolidated Laundries was quite different. Had the documents there been made available to counsel for the defense upon cross-examination, the testimony of the Government's principal witness might have been so discredited or altered that the very basis for the court's factual determinations might have been shaken and changed. Here, however, the "non-disclosed" documents merely supply additional evidence that Kirby knew or should have known that the value of the stock he was acquiring was substantially greater than the price paid. The documents would undoubtedly have given the plaintiffs in Zenn greater fire power to train upon the enemy but judging by the plaintiffs' and objectant's briefs a rather substantial barrage was laid down. Alleghany's real dissatisfaction must be based upon the Referee's and Supreme Court's decisions. There was certainly enough evidence presented to justify a rejection of the proposed settlement. Yet the stockholders suing on behalf of Alleghany, represented as they were by able counsel, chose settlement. Whatever our thoughts may be as to the merits of the derivative suits and the wisdom of the settlement, these issues are not before us.

Alleghany advances as a legal proposition that Kirby was under an affirmative duty to present facts which might aid his adversaries in establishing his liability. No authority is cited for this proposition which would require a defendant accused of fraud to make an investigation of the files of the companies involved and to tender voluntarily all relevant documents there discovered. Even then such a defendant would be in peril of having the settlement vacated if in the future other letters or documents were discovered. No sup-

port for this legal theory comes from Alleghany's citation of cases establishing the duty of self-dealing directors to make full and frank disclosure. For this failure the Zenn and Breswick suits were brought. On the merits Kirby and Young may well have obtained substantial financial benefits for themselves by wrongful self-dealing. But the *bona fides* of the 1950 stock exchange were not the issue for determination by the district court here; the issue was whether there was a sufficient basis for a federal court to nullify a settlement in a case involving fraud which had been judicially approved in the state court.

Appellant cites Masterson v. Pergament, 203 F.2d 315 (6th Cir.), cert. denied, 346 U.S. 832, 74 S.Ct. 33, 98 L.Ed. 355 (1953); Cohen v. Young, 127 F.2d 721 (6th Cir. 1942), cert. denied, 321 U.S. 778, 64 S.Ct. 619, 88 L.Ed. 1071 (1943); and Heddendorf v. Goldfine, 167 F.Supp. 915 (D.Mass. 1958) as supporting the principle that settlements in derivative actions should be set aside if accomplished through concealment by wrong-doing directors. In Masterson, supra, the appeal was from an order of the district court approving a compromise in a derivative suit. The order was affirmed although the dissenting judge would have vacated the settlement and directed the trial to proceed on the merits. The majority noted the difference between a trial on the merits and a review of a settlement, saying, 203 F.2d at 330:

> "We must not forget that what was submitted to the District Court was a proposed settlement. A settlement is the result of a compromise and in effecting a compromise each of the parties expects to make some surrender, in order to prevent unprofitable litigation, effect upon its credit, the wasting of time on the part of its officers that should be devoted to the

success of its enterprise and, so, compromises are generally approved by the courts."

In Cohen, supra, the same dissenting judge wrote for the rejection of a settlement but on the ground that the district court was in error in not considering the available evidence and in relying merely upon the recommendation of a majority of the attorneys. The case was remanded so that further testimony could be taken.

In Heddendorf, supra, the issue before the district court was whether the settlement of a stockholders' derivative action should receive court approval. The court initially disapproved the settlement because of its failure to safeguard the stockholders against further wrong but left the door open for a settlement plan which contained protective provisions (167 F. Supp. at 923). In a supplemental opinion, approval was withheld until certain information was supplied under oath (id. at 926). Finally, the second compromise was approved (id. at 929). These steps were not unlike the proceedings in Zenn and Breswick whereby ultimately a settlement satisfactory to court and counsel in these cases was reached.

More analogous is the case of Feldman v. Pennroad Corp., 155 F. 2d 773 (3d Cir.), cert. denied, 329 U.S. 808, 67 S.Ct. 621, 91 L.Ed. 690 (1946). There a settlement of a stockholders' suit in the Delaware state court was approved by the Court of Chancery after a hearing upon which many parties appeared in opposition. The Supreme Court of Delaware affirmed the Chancery Court's decision. During this proceeding, the plaintiff Feldman brought an action in the federal court to enjoin the consummation of the proposed settlement. The district court dismissed the complaint. On appeal, the court of appeals affirmed, saying: "In the ab-

sence of bad faith, the Delaware law affords her no right to judicial interference with the settlement merely because the amount agreed upon in settlement is deemed by her to be inadequate." (155 F.2d at 776.) The court referred to the state court's finding "after a full hearing that the Pennroad directors acted in good faith in agreeing to the settlement," and held that the "determination of these basic facts by the Court of Chancery is, therefore, now conclusive between the plaintiff and Pennroad and she is estopped from further disputing them in the present case."

Tempting though it be to retry the settlement proceeding in the New York Supreme Court and, possibly with the subconscious advantages of hindsight, to reach different conclusions and draw different inferences from those of the Referee and court therein, this is not our appellate function. The district court had to resolve the issue before it, namely, whether to vacate the State court judgment approving the settlement because of Kirby's alleged failure to produce certain documents. Essential to such resolution were such fact findings as Kirby's possession and control of the documents, his knowledge of their contents and his suppression thereof. Upon the trial, the counsel representing Alleghany had full opportunity to examine and cross-examine the principal alleged culprit, Kirby, Pomerantz (counsel for the stockholders in the Zenn suits), Graubard (counsel who so vigorously opposed the settlement), Purcell, Shipman, the various attorneys who were instrumental in bringing it to a conclusion in December, 1959, and other witnesses. After hearing these witnesses, the court found "that plaintiff has failed to establish that defendant Kirby committed a fraud upon the State court or its Referee in failing to produce documents at the hearings before the Referee which were not called for at the hearings and most of which were not in

his possession but were in the possession of IDS." 218 F. Supp. at 186. In the light of the concession by plaintiff's counsel that he could not tie the financial projections sought to be introduced to Kirby's personal knowledge, the district court's refusal to speculate or infer that Kirby must have seen them cannot be characterized as "clearly erroneous." In view of this factual finding, it is unnecessary to consider the district court's alternative conclusion that plaintiff cannot collaterally attack the settlement in the State Court because "The conduct of Kirby, if fraudulent, was not extrinsic fraud as defined by New York law."

Affirmed.

Opinion of Judge Kaufman

KAUFMAN, Circuit Judge (concurring):

As my brother MOORE has amply demonstrated in his able opinion, the New York State judgment which we are here asked to overturn was rendered only after extensive hearings, exhaustive arguments of counsel, and protracted negotiations. Unlike the situation which prevailed at the time of the exchange transaction itself, moreover, the Zenn settlement proceedings did not involve a body of silent and quiescent shareholders, meekly trusting their directors to act in the best interests of the company. Rather, it is reasonable to infer from the nature of the controversy that at the time of the Zenn hearings the shareholder-plaintiffs and their experienced and zealous attorneys recognized Kirby and his co-defendants as bitter antagonists, whose interests in the settlement negotiations were diametrically opposed to those of Alleghany. Under these circumstances, therefore, while I find it unnecessary to determine whether the director-defendants were under any greater obligations than those customarily borne by an adverse party in a lawsuit,

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I agree with Judge Moore that Alleghany has failed to establish that we should take the extraordinary step of setting aside a final and binding state judgment in a wholly collateral action.

In light of my brother FRIENDLY's considered dissenting opinion, however, a few additional remarks would seem to be in order. Thus, although the case was argued—both in the District Court and on appeal—primarily if not exclusively on the theory that Kirby's failure to produce certain documnets constituted fraud sufficient to vitiate the state judgment, the dissenting opinion appears to see the case in a somewhat different light. Conceding that personal dereliction on Kirby's part was not established, it appears to suggest that this is irrelevant, and that the withholding of material documents from the eyes of the referee in Zenn justify setting aside the judgment, even if this nondisclosure was the work of Young and Purcell, and not that of Kirby. The underlying premise of this line of reasoning seems to be that Kirby ought not be permitted to claim the benefit of a favorable settlement if that settlement was procured by fraudulent means—even if he was not a party to the fraud.

This approach to the case—which focuses on the activities of Young and Purcell, rather than that of Kirby—has much to commend it at first blush. In terms of its reliability as a fair and genuine adjudication of the adequacy of the settlement, the referee's approval would seem to stand on no firmer grounds merely because the fraud which kept material documents from the attention of the Zenn plaintiffs may not be directly imputed to Kirby. But if I am thus willing to concede the validity of this sort of analysis as a general proposition, I am unable to agree that the conduct of Purcell and Young was such as to warrant overturning the judgment as against Kirby.

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As I understand it, the crucial document which Purcell and Young are alleged to have withheld is Exhibit 365 for identification, a comparison of actual 1949 earnings, with actual and projected figures for 1950.[1] Since the actual figures were before the Zenn referee, the key item here is, of course, the projected outlook for 1950. And it is the failure of Purcell and Young to come forward with this projection which forms the basis of the claim of fraud.

But the majority opinion has quite properly noted that the particular pieces of paper which comprise Exhibit 365 could not have been seen by anyone at the time of the exchange transaction—let alone by Kirby. Since the document contains actual figures for 1950, it could not possibly have been compiled before May, 1950, when the exchange transaction was consummated. Further, as both majority and dissenting opinions observe, the essential information conveyed by Exhibit 365 *was* before the Zenn referee, and was spotlighted by the vigorous arguments of counsel. Thus, the spectacular improvement in the earnings of the IDS mortgage department, almost wholly responsible for the large increase in IDS total earnings, was predicted in Purcell's letter to Young and Kirby, which was, in turn, introduced in Zenn. Indeed, the primary difference between Exhibit 365, which was [not introduced and the Purcell letter, which was,]*, turns on the fact that the former

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[1] I do not take it as suggested that either Young or Purcell acted "fraudulently" in failing to produce the handwritten Purcell-Young note. Whatever the duty to be imposed on defendant-directors or their "confederates," I would hardly think that it encompasses production of this sort of informal memorandum. Since the note is prominently mentioned in the dissenting opinion, however, I would add that Purcell seemed to consider "not too helpful" the spread between *actual* 1949 earnings of $1,515,401, and *actual* 1950 earnings of $8,600,444, figures which *were* before the Zenn referee, rather than projected 1950 earnings of $5,992,168.

*Bracketed material omitted from official report, 333 F. 2d 327, 337. Crossed out material erroneously printed in official report.

also indicated that the substantial ~~was not introduced, and the Purcell letter,~~ gains in the mortgage operations would not be nullified by losses of other IDS divisions.

In short, the Zenn referee was informed of the projected vast increases in the earnings of the mortgage department; he was not told that the other IDS divisions were not expected to lose money. But even if his failure to learn of this last piece of information may be attributed to the nondisclosure of Purcell and Young, I cannot find this sufficient to warrant upsetting the New York judgment as against Kirby.

In so deciding, I agree with Judge MOORE that the relevant standard cannot be that provided by our decision in United States v. Consolidated Laundries Corp., 291 F.2d 563 (2d Cir. 1961), or whether there is any fair basis for thinking that the undisclosed documents "might have" changed the result. Consolidated Laundries, a criminal prosecution, involved the negligent failure of the government to produce information relevant to the defense; our result was derived from our continuing duty to supervise the administration of criminal justice in the federal courts. Here, on the other hand, we are asked to set aside a state judgment in a civil action because of fraud which was allegdely committed by parties other than the present defendant. In such a situation, considerations of *res judicata* and comity must be taken into account; institutional imperatives and the necessity of finality in litigation are of far greater significance. In short, even if the obligations of a court passing on the settlement of a derivative suit may be analogized to those of a criminal court, my reply is that we are neither in the position of passing on the settlement or reviewing a criminal conviction. By its action in Zenn, the Supreme Court of New York passed on the settlement of this deriva-

tive suit; in the present proceeding, we are asked to set that judgment aside. Since we are hardly entrusted with the obligation of ensuring that the states do perfect justice in the civil litigation properly before them, we have absolutely no warrant in considering this settlement as if it were now being presented for our approval as an original matter.

I agree with my brother MOORE that Alleghany has failed to establish that the New York judgment should be set aside.

Opinion of Judge Friendly

FRIENDLY, Circuit Judge (dissenting):

I can perceive no principle that would eliminate or even lessen the fiduciary obligations of directors who wish to settle a derivative action wherein they are charged with self-dealing. At least I cannot when, as here, they remain in control of the corporation, its officers, and its files relevant to the merits of the claim and consequently to the providence of the settlement. When they seek to extinguish the corporation's claim, they are dealing with the entity whose interests have been entrusted to them just as much as in the earlier transaction; I see no reason why their obligation of fair dealing and full disclosure to a court passing on the settlement should be a whit less than their previous duty to disinterested co-directors and to stockholders.

I agree nevertheless that a director thus sued is not bound actively to ferret out information that will promote the case against him or show the improvidence of a settlement to which he has persuaded a stockholder's lawyer to agree; and that insofar as the plaintiff's case here hinged upon establishing personal dereliction by Kirby with respect to the settlement hearings, this was not made out. But although

the trial was largely conducted on one or the other of these theories, the complaint did not so limit the plaintiff, and on at least one occasion its counsel articulated another course which, in my view, it was entitled to pursue and which might well lead it to victory.

In examining Purcell and seeking to obtain admission of the evidence discussed below, counsel argued that "if Mr. Kirby entrusts the responsibility to some extent of his being a director of Alleghany, if he entrusts some of that responsibility to Mr. Young, then Mr. Kirby cannot avoid accepting the consequences of whatever Mr. Young may have done * * *." When one of a group of fiduciaries accused of illegal self-dealing conceals from a court facts which pertain to the liability of his associates as well as himself, a settlement so procured is voidable as to all. A partner for whose benefit the facts were concealed can no more preserve a settlement thus obtained than the one who was on the front line. If, as the evidence shows, Young, Kirby and Purcell conspired to make an unlawful appropriation of Alleghany's investment in IDS Class A stock, which was then challenged by suit, they remained bound to the end. Kirby recognized this rather pointedly when, late in 1959, he sent Young's widow a copy of counsel's letter advising him of his enormous potential individual and even more enormous potential joint liability, which Young shared, and implored that she "fully realize how important it is to you and me that there should not be the slightest indication of disharmony in our ranks and that absolutely nothing should be done at this time to indicate anything like that." Kirby had hardly heard of Mr. Justice Brandeis' opinion in Jackson v. Smith, 254 U. S. 586, 41 S.Ct. 200, 65 L.Ed. 418 (1921), but his instinct was sound.

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That the diversion of the IDS Class A shares from Alleghany's treasury was a joint enterprise of Young and Kirby, in which Purcell, like them a director of Alleghany, joined before its consummation—if indeed he had not been a party to it from its inception—will appear from what is said below. All three were named as defendants in the state court action, Zenn v. Anzalone, wherein stockholders sought damages or rescission; although Kirby had not been served in that action, he had been in a similar action by Zenn in the federal court. All three had an interest in promoting the settlement here attacked. Young and Purcell, but not Kirby, testified at the hearings before the Referee. There was evidence, here excluded, which showed, at minimum, that Young and Purcell permitted the Referee to pass upon the settlement when they should have been aware that crucial and damaging evidence, eagerly sought by an objector and well known to them, was not before him. If the settlement was voidable on that account against these members of the conspiracy, it is no less so against one who chose to remain secluded in Morristown, New Jersey, while his partners carried the heat of the battle in New York.

Plaintiff's discovery in this action found in Alleghany's files a handwritten letter by Purcell to Young on July 27, 1954, at a time when, as the letter shows, Young was engaged in settlement discussions with Pomerantz, general counsel for the plaintiff stockholders in Zenn. Purcell, one of Alleghany's nominees on the board of IDS, had resigned as a director of Alleghany in March, 1953, to become president and later chairman of IDS, a post which he retained until the summer of 1955. With this Purcell sent a letter dated July 26, 1954, from Waag, Vice President and Controller of IDS, to him; Waag's letter enclosed three schedules. Purcell suggested that Young "note among other

things on page 2 of the income account attached to the 'Comments on Operation' for December 1950 that Income from Operations, i.e., before taxes or capital transactions, *had been projected at $5,992,168,* but turned out to be $8,600,444. *This may not be too helpful* as Income from Operations in 1949 was only $1,515,401." (Emphasis supplied.) One of the schedules reproduced this forecast.

Indeed it would not have been "too helpful." The projected 1950 income before taxes or capital transactions amounted to $20 for each IDS share Young and Kirby acquired for $8.15 from Alleghany in the exchange transaction.[1] Yet their defense to the stockholders' claim hinged largely on a contention that the jump in IDS' earnings was not forseeable when they acquired the shares in mid-May, 1950. Waag's letter stated the 1950 projection "was most likely completed in January of 1950 which would indicate that we anticipated a considerable improvement in our mortgage operations."[2] In his testimony in this case Purcell admitted having seen the full 1950 projections "early in the year" although not before his return from Europe around April 12. In any event, Purcell's request to Crabb, President of IDS, on May 10, five days before the exchange

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[1]Apparently because of the nature of IDS' business, taxes took a much smaller bite than in the case of the usual corporation. Thus, in 1950, when pre-tax income amounted to $8,628,745, income taxes were only $2,592,000, leaving net income of $6,036,745—slightly over $20 per share.

[2]Appellee argues that Waag erred as to the date, since the projection found in the IDS files was dated April 14, 1950. The latter seems to be a somewhat differently organized projection in which the corresponding item for earnings before taxes and nonrecurring transactions was $5,641,150, but the addition of earnings of subsidiaries produced a total of $7,140,850. In any event the Alleghany's stockholders' meeting was not held until May 3 and the exchange was not consummated until May 15, 1950.

took place, for additional copies of the IDS projections showed that at least by this date, copies were in his possession. Since during April Purcell was endeavoring to acquire for himself $125,000 worth of IDS Class A stock in connection with the simultaneous acquisition by Young and Kirby, the likelihood that he paid close attention to the projections as soon as they became available is overwhelming. Purcell's letter of February 11 to Young and Kirby informing them of the improved earnings projected for the mortgage department showed that Purcell was attentive to whatever predictions were available. Projections were of unusual importance at IDS during this period because of the company's heavy cash commitments to redeem maturing investment certificates in the next two or three years. As Kirby testified in this case, had the earnings been insufficient to finance their redemption, IDS could have encountered serious financial difficulty. On the other hand, as is invariably true of highly "leveraged" debt-heavy structures, once a sufficient flow of cash was assured to cover these commitments any further increases in operating profits, such as this projection foretold, would predictably cause a dramatic increase in net earnings. The IDS files also yielded a projection using the same figure for 1950 (with a handwritten notation that the estimate of underwriting income was "very conservative") and showing that for the years 1951-54 consolidated income before capital transactions and income taxes would range from $3,860,300 to $5,265,750. Since Purcell must have been in communication with Young during April and early May, 1950, as to being cut in on the exchange, it would be hard for a trier of the facts to resist the inference that he told the good news to his associate; no one so brilliant and experienced as Young would fail to recognize five years later what ad-

vantage would accrue to astute counsel armed with Purcell's handwritten note and its enclosures.

What happened to Purcell's note and the enclosures cannot be precisely determined on this record. Two of the schedules attached to Waag's letter, a retrospective quarterly analysis of income for 1949 and 1950, and a list of the larger items included in commissions and participation project fees for 1950 by quarters were offered in the Zenn settlement hearings by Pomerant's colleague, Haudek, who was advocating the settlement; apparently he had obtained them by inspection of Alleghany's files. These were in no way damaging to the defendants or the proponents of the settlement since by their very nature they could not have come into existence until after the end of 1950 and the information they divulged could not have been known before that time; indeed, by showing that the greatest jumps in income were in the last three quarters and the most spectacular one in the fourth, they lent some support to the argument that the huge 1950 earnings were manna of whose prospective descent Kirby, Young and Purcell could hardly have been aware. But the seriously damaging schedule, containing the projection of 1950 income, which Waag's letter said had been prepared in January and surely was available by mid-April, did not find its way into evidence in Zenn.

Responsive to Judge Dawson's rulings that he would not admit the handwritten note and that he would admit Waag's letter and the schedules only on proof that these were in the Alleghany files at the time of the settlement hearings, plaintiff's counsel argued (1) that the discovery of the projection in Alleghany's files, where Haudek had earlier found the two schedules which had accompanied it, warranted the inference that the entire group of papers had

been in Alleghany's possession at the time of the Zenn hearings, and (2) that the non-production of Purcell's note, Waag's letter and the damaging schedule either by Haudek or by Graubard, counsel opposing the settlement, warranted an inference that Alleghany had not included them in the files made available for inspection. The argument seems sound enough. As to the first branch, we have called attention in recent opinions dealing with the tardy discovery of documents to "the evidentiary principle that the subsequent existence of a fact supports the inference of its earlier existence, when the subsequent condition is one which ordinarily would not exist unless it had also existed at the earlier time," United States v. Consolidated Laundries Corp., 291 F. 2d 563, 569 (1961); Kyle v. United States, 297 F. 2d 507, 511 (1961); this, particularly when reinforced by the earlier finding of two of the schedules in the Alleghany files, was at least enough to transfer the burden of showing how the missing documents had since come into Alleghany's possession if they were not there in 1955. The only other likely possibility would seem to be that they had remained with Young, but that would not have helped since Graubard had asked for and supposedly received all such papers in Young's possession. The second branch of the argument was supported by Pomerantz's testimony that he had reviewed the available files "very closely," and that his "best recollection is that we were shown no statements which contained estimates in futuro," by Graubard's testimony that he could not recall ever having seen a projection for 1950 and that "The probabilities are that I did not see anything which would indicate that the earnings would be so many times the sale of the stock. If I had, I would have introduced it in evidence, had I known," and by the inherent improbability that a lawyer so able and diligent would have

failed to appreciate the significance of the schedule, especially when this was flagged for him by Purcell's handwritten note and it would have filled the very gap in his proof of which he was acutely aware.

However, I find it unnecessary to decide whether we could properly upset Judge Dawson's ruling that plaintiff had not sufficiently discharged the burden of showing that at the time of the settlement hearings the portion of the Waag file not offered by Haudek was in the possession of Alleghany or Young and was withheld from the documents made available for inspection. For even that view leaves Young and Purcell knowing or chargeable with knowing that the Referee was deciding without the benefit of evidence which they knew to exist—a full official projection showing the enormous 1950 earnings reliably expected for IDS, which had been known to Purcell and almost certainly to Young before the consummation of the exchange, the importance of which Purcell had sharply brought to Young's attention before the settlement negotiations, and which they and their counsel, who were also acting for Alleghany, knew to be precisely what the attorneys for the stockholders—Pomerantz before the settlement and Graubard thereafter—had been searching for without result.

Preparatory to the taking of the depositions of Young and of Wallace, Alleghany's secretary, in December, 1954, Pomerantz had made a demand for the production of documents from Alleghany, including "(35) All forecasts or budgets concerning IDS and its subsidiaries, prepared by or for the use of Alleghany or IDS and their officers and directors, during the year 1949, the first six months of 1950 and the last six months of 1953," and Haudek made this demand still more general when the depositions were taken. The

quest for projections was continued by Graubard at the hearing before the Referee. He said he wanted "anything bearing upon the earnings of I. D. S. and, therefore, the value of its stock, at the end of 1949, during the Fall of 1949, and the Spring of 1950." In examining Wallace, he repeated the request, made during the depositions, for "any kind of forecast, both as to the nature of earnings from mortgage operations, as well as any other aspects of the business of I. D. S." and was told "There are no such documents in Alleghany Corporation's files, unless we find those various reports we are looking for." Complaining "that the poor Alleghany files are emaciated, they have been deprived of nourishment with regard to this 1949, 1950 transaction," Graubard asked for Young's personal records, which as he later stated, counsel for Young made available. Apparently sensing that something was missing, Graubard noted in examining Young that he had "had some difficulty in finding the files and reports of Alleghany Corporation in regard to I. D. S. affairs for the period in question, 1949-1950"; this led to a chorus of objections by Pomerantz and Young's counsel and a ruling by the Referee striking out the offending remark. Later Young assured Graubard that his policy was never to destroy or remove or countenance the destruction or removal of files because he "felt that the first consideration of management was to conduct itself so that it never had anything to destroy . . ." This lofty concept of an officer's responsibility scarcely comports with permitting the Referee to approve a settlement for a few hundred thousand dollars of a liability for self-dealing ranging into the many millions without the benefit of evidence, which Young knew to be not "too helpful," relating to a vital element in the case. Of course, Graubard knew IDS had made projections; the

point is that he had been given reason to think the record before the Referee contained everything Young and Purcell knew in the spring of 1950, whereas they knew it did not. As proponents of a transaction whereby they would purchase from Alleghany its cause of action against them, Young and Purcell had a duty to see that the Referee had that evidence; court approval of an advantageous bargain granted in ignorance of documents, known to Young and Purcell, showing that they had this optimistic projection in early 1950, no more finally settles the liability of themselves and Kirby than did the stockholders' approval of the underlying bargain in 1950, similarly procured without disclosure of the projection. Cf. ALI, Restatement of Torts 2d (Tent. Draft No. 10), § 551(2)(a).

Since in such complicated litigation some relevant documents will inevitably be overlooked, the undesirability of reopening judgments demands that judicial approval be final unless the undisclosed evidence is of real importance and not merely cumulative of other evidence that was received. Kirby argues, and my brothers seem to agree, that the whole matter of the complete IDS projection of 1950 earnings is a tempest in a teapot because the record before the Referee did contain a partial projection of which Young and Kirby admitted knowledge. This was in a letter to them dated February 11, 1950, in which Purcell, before leaving for a vacation in Europe, gave "a brief report on the present situation at Investors Diversified Services, Inc. and the accomplishments of the nine months since our acquisition." The letter included a statement that reported 1949 income would reflect a large accounting adjustment to cure a deficiency in the certificate reserve account accumulated in prior years—one of the serious problems confronting IDS so featured before the Referee—and that "During 1950 the Mortgage Department forecasts, conservatively, $8,315,000 gross in-

come from mortgage operations (not including interest), with a net, before home office expenses, of $5,720,000." Kirby then points out that Graubard, in his memorandum opposing confirmation of the Referee's report by Mr. Justice McGivern, argued that Purcell's letter "completely explodes the tortured analysis by which the Referee convinced himself that, although defendants had reason for cautious optimism, they did not foresee the 'spectacular' IDS earnings for the year 1950."

Graubard surely did the best he could with what he had, and one may indeed wonder whether anything short of proof that Young and Kirby had received a gold plated guarantee of IDS' 1950 earnings would have swayed the Referee, who went out of his way to compliment them on their presentation to the Alleghany stockholders, as to which more below, and concluded that a trial court would give judgment in their favor.[3] But there was an enormous difference

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[3]It should be remembered that the Referee approved a settlement under which the total cash payment to Alleghany was $1,000,000, $300,000 of which had been added to the proposal that Pomerantz had accepted as a result of the efforts of counsel for plaintiffs in the federal court action, Breswick v. Briggs. Although the state court accepted the Referee's report, Judge Dimock rejected it for failure by the Referee to hear the Breswick plaintiffs "on the question of the settlement value of the whole case and its relation to the value of the additional offers," and directed further hearings. Kirby, who had not previously testified in any of the proceedings, was scheduled to be the first witness at the reopened hearings; an associate testified that Kirby "looked upon his appearance as a witness with somewhat—with more or less horror, because he had been told by Ireland that Mr. Young had perjured himself in his testimony * * *." After receiving an opinion from counsel that his potential personal liability on the IDS exchange transaction approximated $22,800,000 and his potential joint liability an additional $39,350,000, computed on a price of $1,600 per share for the stock acquired for $8.15, plus over $70,000,000 for other items, he added to the settlement another $1,100,000, which he estimated would cost him only $99,000 after taxes; Young's estate contributed another $900,000. One of the objectors having died and the others being tired out, this was accepted without the further hearing ever being held.

between a paragraph in a general letter, commenting on the prospects of one department of IDS, a paragraph not even noted in the Referee's report, and proof that shortly before making the settlement, Young and Purcell had been reminded of the existence of an official company forecast in early 1950, covering all departments, which negated any fear that the anticipated quadrupling of income from mortgage operations would be cancelled out and showed instead that this would be enhanced by other divisions.[4] There was at least a much greater chance that such evidence, developed as Graubard would have developed it, might have made some impression upon the Referee (who, because of the federal court litigations, did not file his report, dealing with a variety of claims of malfeasance, for three years after the hearings), or, if it did not, upon the Supreme Court justice who had appointed him, or, if it did not, that such evidence might have encouraged the objectors to go on to the Appellate Division, or that it might have led Judge Dimock to refuse to lift the federal court injunction that had blocked the settlement.

I cannot agree that when judicial approval of a settlement by a fiduciary has been procured by culpable nondisclosure of evidence by a confederate, the test of materiality applicable on motions for a new trial on the ground of newly discovered evidence has any relevance; indeed, in the very decision cited by the majority, Judge Kaufman carefully distinguished between newly discovered evidence *simpliciter* and the recantation of a witness, 131 F. Supp. at

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[4]The directors' answering memorandum before Mr. Justice McGivern minimized the Purcell letter of February 11 as merely reporting "favorable trends in certain aspects of IDS activity" and touching "only a few of the multitude of problems and activities of the Company."

120. The test should be more nearly that applied by us in United States v. Consolidated Laundries, supra, 291 F. 2d 563,[5] or by the New York courts in Matter of Lautz, 128 Misc. 710, 220 N.Y.S. 782 (Surr. Ct., Erie Co. 1927); and Boston & Maine R. R. v. Delaware & Hudson Co., 238 App. Div. 191, 196, 264 N.Y.S. 470, 477 (3d Dept. 1933)—whether there is any fair basis for thinking the undisclosed evidence *might have changed* the result. Here the evidence could well have done that.

I say this because, with full appreciation of the dangers of reliance on hindsight, Graubard's objections were so strong that almost anything more might have sufficed to tip the scales. Although my brothers seem to concede the inequity of the exchange transaction, this scarcely conveys the picture. Alleghany had decided to go into IDS in the spring of 1949, after a most thorough investigation. It picked up 48,225.61 shares of the non-voting Class A stock on the market for $8.15 per share; at the same time it bought some 17,745 shares of the voting stock for around $11. The control block of 85,660 shares of voting common

[5]Although the decision in Consolidated Laundries was based upon our duty to insure the fair administration of criminal justice in the federal courts, there are enough similarities between a prosecution and a derivative suit against self-dealing fiduciaries to make the test of materiality in that decision highly pertinent. Both the prosecutor and the director-defendant are charged with the duty of assuring that their adversaries are honestly and fairly treated. Just as a criminal court is entrusted with the protection of defendants from overzealous prosecution, a court passing on the settlement of a derivative action is charged with the protection of the absent shareholders, whose interests may be represented inadequately or not at all by the time a settlement has been negotiated. Where deliberate dereliction on a director's part has prevented the court from safeguarding the interests entrusted to it, a reasonable possibility that the undisclosed evidence might have led to disapproval or to a substantial increase in a settlement should suffice for reopening.

was bought for $20. These prices were paid after a year, 1948, in which IDS had earned $374,355 or little over $1,25 per share. As 1949 wore on, Young and Kirby could not help but realize that Alleghany had made a fine investment, even though they could hardly have foreseen just how fine. By mid-August one of the consultants who had initially surveyed IDS for Alleghany accurately predicted IDS' 1949 income would amount to some $1,200,000 to $1,-500,000, or more than $5 per share.

This was the background when seven of Alleghany's ten directors—including four officers, Kirby, Young, Purcell and Anzalone—assembled for a scheduled meeting on December 6, 1949. The agenda had not mentioned that any action with respect to the IDS stock in Alleghany's portfolio was contemplated.[6] The minutes recited that the Chairman, Young, "stated that among the securities which had been considered as available to be offered to stockholders in exchange for the Corporation's outstanding preferred stocks was the company's holding of 48,225.61 shares of Investors Diversified Services, Inc. Class A Common Stock" but that counsel had advised that no offer of these shares to all stockholders "could be made without registration with the Securities & Exchange Commission which, in view of the size of the holding and the costs and delays incident to registration, would not be worthwhile." He therefore recommended, in addition to an exchange offer not involving the IDS shares which was being made to all preferred stockholders, a further offer which would give "the officers" of Alleghany the right to exchange holdings of Alleghany preferred stock for the holdings of IDS Class A. His recommendation was that the exchange ratio

[6]The absentees included two lawyers and an investment banker.

should "be not less favorable to the Corporation in relation to the respective market prices of the Alleghany Preferred stocks received and the Investors Diversified Services, Inc., stock delivered than the exchange ratios which are accepted by the company pursuant to the public offer." Discussion developed some concern over the fact that the current "market" price of the IDS Class A shares had dropped to $5.50 per share—in fact there was no market, as the Referee found; the directors, watchful for Alleghany's interests to the extent of thinking it might indeed seem peculiar to allow officers to acquire the IDS shares for an amount approximating current earnings, thought Alleghany should at least recover its cost. The resolution accepted Young's recommendation with the sole change that Alleghany was to get the higher of its cost or the market price of the IDS shares at the time of exchange.

Although it is understandable why registration problems made it impracticable to offer the IDS Class A shares, representing a relatively small investment, to all stockholders of Alleghany, that in no way explains why they had to be offered to anyone. Alleghany had scarcely acquired them after prolonged study, that very year, just in order to have something "available" to exchange for its own preferred stock at the better of cost or the price on a market that was so thin as to be meaningless; its portfolio contained many securities, having a readily ascertainable market value which could be and were used to that end. The company's program of reacquisition of preferred stock had indeed been advantageous to the common stockholders and to preferred stockholders who did not exchange, but there was no crisis demanding that it immediately reacquire 2420 shares of Preferred Series A from Kirby, the same

amount from Young, and 10 shares from Anzalone. The non-voting character of these IDS shares was no obstacle to their retention when Alleghany held 90% voting control. It must have been apparent that these shares were peculiarly unsuitable for an exchange offer to preferred stockholders, particularly to insiders. If IDS had the bright prospects that had led Alleghany to make its investment, all the stockholders should benefit; on the other hand, if the problems confronting IDS were as serious as Young and Purcell were later to testify, it was scarcely right that the officers of Alleghany, including such an inconspicuous one as Anzalone, should bear a disproportionate share of the burden. Evidently some such considerations occurred to the draftsman of the resolution, who inserted another reason for the offer, namely, that "it would give the officers who accept the Class A stock of Investors a further incentive to make successful the operations of that company in which Alleghany will continue to hold its large controlling interest." One might suppose that Young's holdings of 10,083 shares of Alleghany Preferred Series A and Kirby's of 27,858 such shares plus 516,500 common shares would have given a fair degree of incentive, and if Kirby or Anzalone made any contribution to the success of IDS in the years after the exchange, this does not seem to have been called to the attention of the many tribunal that have been concerned. The Alleghany officer who was truly active in IDS was Purcell, who had brought it to Alleghany's attention, kept a careful watch over it from the outset, and later became its president and moved his office to its headquarters in Minneapolis. Since Purcell owned no Alleghany preferred, his reward was to come in a different manner.

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On January 30, 1950, Alleghany authorized him to buy $185,000 worth of IDS common stock for his own account at not to exceed $10 per share, and guaranteed him against loss on such purchases. By the date of the Alleghany proxy statement, April 6, 1950, he had picked up 3,828 Class A shares at an average cost of $5.562. Since these purchases had driven the price of IDS Class A from 5 nearly to 10, Alleghany, on April 26, 1950, a week before the stockholders' meeting, sent out additional proxy material announcing that if Purcell was unable to complete this program for personal participation in Alleghany's corporate opportunity, Kirby and Young would supply him with the necessary IDS shares, at cost, out of those coming to them under the exchange offer. On May 9, Purcell wrote Young and Kirby, noting that if he "were now to enter the market the price of the stock would probably be driven very high," a result which "I believe we all agree * * * is undesirable"; he wished to purchase 6,366 shares from each of them at $8.1453 per share, as he subsequently did.

Although at the very least the situation demanded maximum endeavor to insure that Alleghany's stockholders understood exactly what was afoot,[7] the effort was unsuccessful. The Alleghany proxy statement, which sought approval of the exchange, gave no financial information about IDS as a company. With respect to the IDS stock it told that the shares to be offered the officers had cost

[7]In addition to the fact that the exchange was extremely advantageous to the officers on facts admittedly known, it is exceedingly doubtful whether the resolution passed by the directors had any legal status under the quorum requirements in Alleghany's certificate of incorporation; hence only action by the stockholders could give the exchange even formal validity.

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$8.1453 per share, had a market price of $5.50 at the time of the resolution of December 6, 1949, and had a current market price of $9 bid, $9.75 asked, whereas the voting common had been acquired at an average cost of $18.25 per share. Another portion of the proxy statement revealed the arrangement with Purcell and what he had done under it. On this basis, to the uninformed and unalerted stockholders, an exchange of IDS Class A shares that would give Alleghany the higher of cost or market would seem not unattractive, and the whole matter, involving an investment of $400,000, could hardly have appeared momentous. Only the stockholder who might wonder about the unusual disparity in cost between the voting and the non-voting stock would see cause for inquiry. For further information about IDS he would have to turn to Alleghany's Annual Report, mailed to him a fortnight before. If this had escaped the treatment usually given such reports, he would not have learned much. Although he was told that IDS' 1949 net income was "approximately $1,631,000, compared with $374,335 for 1948," no attempt was made to translate these totals into per share figures. A stockholder wishing to determine that would either have had to go to a financial manual to learn IDS' capital structure, or, if he returned to the Alleghany proxy statement, arrive at this figure by converting Alleghany's holdings into the total by first dividing the shares of each class which Alleghany owned by the percentage of its ownership and then adding the quotients—this to be followed by dividing the earnings by the sum so obtained. Granted that this computation is well within the power of the ordinary human mind, one may wonder how many Alleghany stockholders bothered to perform it. How

simple it would have been for Alleghany's management to relieve the stockholders of this necessity by saying that IDS' 1949 earnings of $1,631,000 were more than $5 per share! And what illumination this would have shed on the succeeding comment that Alleghany regarded its interest in IDS "as a long-term investment," as to which, because of IDS' cash requirements, it did not "expect any return on our investment in IDS for a number of years" but considered the "outlook for eventual profits * * * to be unusually promising." The eventual might have seemed to Alleghany stockholders to be now, at least with respect to the stock acquired at $8.15 per share which the proxy statement, but not the annual report, told them would be exchanged with insiders. And that impression would have been considerably accentuated if Alleghany's management had vouchsafed the information, available when the additional proxy material was sent out on April 26, that although IDS had lost $223,000 in the first quarter of 1949, its pretax income from recurring operations in the first quarter of 1950 exceeded $1,000,000 and that continuation of that trend would produce 1950 earnings exceeding $15 per share! If all this had been supplemented by proof to the Referee that at the time of the exchange Purcell and Young knew IDS was forecasting even higher earnings, could any rational mind have predicted that a court would decide for the defendants?

My brothers rightly shrink from a precedent that would make every settlement of a stockholder's suit the prelude to another in which the proceedings for approval of the settlement would be reexamined at great expense and effort. I too would regret that although, for reasons sketched below,

it might be better if more such suits were tried and fewer settled so long as the procedures with respect to the approval of settlements remain as unsatisfactory as they are. But we would make no such precedent by a reversal in this case. Here we have an unusual situation. After litigation had begun, two of the principal architects and beneficiaries of the self-dealing and the subsequent settlement had their attention dramatically called to the existence of a report, clearly known to one of them and arguably to the other before the exchange, and nevertheless allowed the Referee to proceed to approval, knowing, on the most innocent construction, that this report, although eagerly sought by the objector's counsel, had not been found by him. Such cases will hopefully be rare; the instances in which the corporation or a large stockholder will seek to prosecute them will be rarer still; and the chances of success and consequent reward will not be such as to tempt the typical stockholder plaintiff save in occasional cases where it is as well to have him tempted.

I cannot at all agree with the implication in my brother MOORE's opinion that standard procedures for the approval of settlements afford sufficient safeguards in the "big" case, or that they did in this one. The plaintiff stockholders or, more realistically, their attorneys have every incentive to accept a settlement that runs into high six figures or more regardless of how strong the claims for much larger amounts may be. The percentage allowance in stockholders' actions is "reduced as the amount of recovery passes the million dollar mark," 2 Hornstein, Corporation Law and Practice 253 (1959), see also Hornstein, Legal Therapeutics: The "Salvage" Factor in Counsel Fee

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Awards, 69 Harv. L. Rev. 658, 657-68 (1956); the income tax also plays a role; and a juicy bird in the hand is worth more than the vision of a much larger one in the bush, attainable only after years of effort not currently compensated and possibly a mirage. Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork—as is vividly shown here where the stockholders' general counsel sometimes opposed Graubard's efforts to gain information, although the settlement so vigorously defended before the Referee would have produced less than a quarter as much cash for Alleghany, $700,000, as the $3,000,000 ultimately secured through the efforts of the attorneys for the plaintiffs in the federal court litigation, unrelated to the claim here at issue, and Judge Dimock's initial refusal to lift the federal injunction. To say that "Through its representatives, it [Alleghany] elected to settle" is sheer fiction. Most of the independent Alleghany stockholders had no voice in the selection of their "representatives" or ability to evaluate the settlement these "representatives" had accepted for them. I cannot see how the attorneys proposing the settlement were any more "representative" than the attorney opposing it; the stockholders' true representative was the court, which was allowed to proceed in ignorance of vital information. Alleghany as a corporation never elected to do anything until the very end of 1959, when a directors' meeting presided over by Kirby approved the settlement. Indeed, the directors did not even provide Alleghany with independent counsel, whose supervision of the file search might have avoided the problem here presented.

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This very fact, that directors accused of malfeasance have so much control over the evidence, both documentary and nondocumentary, relating to their misdeed, makes it vital for a court of equity to insist upon a high standard with respect to disclosure at settlement hearings and to subject arguments that a breach was not consequential to a most icy scrutiny. All the dynamics conduce to judicial approval of such settlements. Even when there is objection, the changes are rung on the small proportion of the stock owned by the objector whereas a curtain falls on the equally small percentage owned by the plaintiffs, who quietly annex the stock controlled by the directors and that of the inert mass. Perhaps the ultimate solution may be the appointment of government inspectors to investigate and prosecute, as is authorized in England under the Companies Act, 1948, 11 & 12 George 6, c. 38, §§ 164, 165(b) (ii), 168, 169(4), see Gower, Some Contrasts between British and American Corporation Law, 69 Harv. L. Rev. 1369, 1387-88 (1956), or, in the case of corporations trading in whose securities is subject to the Securities and Exchange Act, assignment to the SEC of an advisory role similar to that conferred by Chapter X of the Bankruptcy Act, §§ 172, 173, 222, 247. In the meanwhile, courts should enforce the most exacting standards of good faith on fiduciaries desiring to settle such serious claims of self-dealing as were here alleged. Appellant is right in reminding us of Judge Cardozo's great words, "Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions." Meinhard v. Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 62 A. L. R. 1 (1928).

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I do not believe this teaching is dead in the New York courts; and we have not hitherto demanded a state decision directly in point before enforcing that salutary principle. See Perlman v. Feldmann, 219 F. 2d 173, 50 A. L. R. 2d 1134 (2 Cir.), cert. denied, 349 U. S. 952, 75 S. Ct. 880, 99 L. Ed. 1277 (1955).

I would therefore reverse the judgment dismissing the complaint and, as defendants should have an opportunity to meet the evidence that was erroneously excluded, remand for further hearing. Since Kirby has regained control of Alleghany, I would instruct the judge to make provision for the continued prosecution of the action free from any control by the present directors.

APPENDIX C

Order and Memorandum of Mr. Justice Harlan Dated April 13, 1965

SUPREME COURT OF THE UNITED STATES

No. ....., October Term, 1964

MARGARET L. HOLT, ET AL.,

Petitioners,

VS

ALLAN P. KIRBY, ET AL.

ORDER

UPON CONSIDERATION of the application of counsel for the petitioners, and of the opposition thereto,

IT IS ORDERED that the time for filing a petition for writ of certiorari be, and the same is hereby, extended for a period of five (5) days after the judgment of the United States Court of Appeals for the Second Circuit on the "intervention" appeal, or to and including April 29, 1965, whichever date proves to be earlier.

s/ JOHN M. HARLAN
Associate Justice of the Supreme Court of the United States.

Dated this 13th
day of April, 1965.

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Order and Memorandum of Mr. Justice Harlan Dated April 13, 1965

Anticipating that the Court of Appeals will act promptly on the "intervention" appeal now set for hearing on April 19, 1965, I am constrained to extend petitioners' time for filing a petition for certiorari from the judgment of the Court of Appeals rendered January 12, 1965, to and including five days next following the Court of Appeals' decision of the intervention appeal, or to and including April 29, 1965, whichever date proves to be the earlier. Petitioners may, within the governing period, apply to me for a further extension of time to file the aforesaid petition for certiorari. Such further application may be made on the papers presently before me, supplemented by any additional papers that either side may wish to submit. I, of course, intimate no view upon any phase of the matters in controversy.

J. M. H.

April 13, 1965

APPENDIX D

Order and Memorandum of Mr. Justice Harlan Dated April 27, 1965

SUPREME COURT OF THE UNITED STATES

No. ....., October Term, 1964

MARGARET L. HOLT, ET AL.,

Petitioners,

VS

ALLAN P. KIRBY, ET AL.

ORDER

UPON CONSIDERATION of the application of counsel for petitioners and of the oppositions of respondents thereto,

IT IS ORDERED that the time for filing a petition for certiorari in the underlying controversy be, and the same is hereby, extended to and including May 12, 1965. This order is conditioned, however, upon the filing of a petition for certiorari on the intervention issue on or before that date.

s/ JOHN M. HARLAN
Associate Justice of the Supreme Court of the United States.

Dated this 27th
day of April, 1965.

Appendix D

Order and Memorandum of Mr. Justice Harlan Dated April 27, 1965

The underlying controversy and the intervention issue are mutually dependent, and although no application is made to me with respect to the latter, I think it is appropriately involved in the proper disposition of this request for a further extension of time within which to petition for certiorari in the underlying controversy.

Because the judges below were so sharply divided on both phases of the matter, I am constrained to give petitioners an opportunity to have them considered together by the Court. However, I do not think the matter should go over the summer, which would be the result were I to grant the full further extension now sought or if the time for filing for certiorari on the intervention issue remains unaccelerated.

Accordingly, I shall extend petitioners' time to file for certiorari in the underlying controversy to and including May 12, 1965, on condition, however, that their petition for certiorari on the intervention issue is also filed by that date. If respondents file their papers in opposition on or before May 24, 1965, this should enable the Court to act on both petitions before the end of this Term. In view of the time elements involved, the parties need not proceed on printed papers.

J. M. H.

April 27, 1965

APPENDIX E

Rule 23, Federal Rules of Civil Procedure

CLASS ACTIONS.

(a) *Representation.* If persons constituting a class are so numerous as to make it impracticable to bring them all before the court, such of them, one or more, as will fairly insure the adequate representation of all may, on behalf of all, sue or be sued, when the character of the right sought to be enforced for or against the class is

(1) joint, or common, or secondary in the sense that the owner of a primary right refuses to enforce that right and a member of the class thereby becomes entitled to enforce it;

(2) several, and the object of the action is the adjudication of claims which do or may affect specific property involved in the action; or

(3) several, and there is a common question of law or fact affecting the several rights and a common relief is sought.

(b) *Secondary Action by Shareholders.* In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States

Appendix E

Rule 23, Federal Rules of Civil Procedure

jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.

(c) *Dismissal or Compromise.* A class action shall not be dismissed or compromised without the approval of the court. If the right sought to be enforced is one defined in paragraph (1) of subdivision (a) of this rule notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs. If the right is one defined in paragraphs (2) or (3) of subdivision (a) notice shall be given only if the court requires it.

APPENDIX F

Securities Exchange Act of 1934

§ 2 (15 U. S. C. § 78b). *Necessity for regulation*

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis

for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit. June 6, 1934, c. 404, § 2, 48 Stat. 881.

Appendix F

Securities Exchange Act of 1934

§ 14 (15 U. S. C. § 78n). *Proxies*

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. June 6, 1934, c. 404, § 14, 48 Stat. 895.

§ 27 (15 U. S. C. § 78aa). *Jurisdiction of offenses and suits*

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by

this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts. June 6, 1934, c. 404, § 27, 48 Stat. 902; June 25, 1936, c. 804, 49 Stat. 1921, June 25, 1948, c. 646, § 32(b) 62 Stat. 991; May 24, 1949, c. 139, § 127, 63 Stat. 107.

Rule X-14A-9. *False or Misleading Statements*

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication written or oral containing any statement which at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the

solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this rule:

(a) Predictions as to specific future market values, earnings, or dividends.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.